A MONTHLY JOURNAL ON INTERNATIONAL TAXATION

International Taxation

VOLUME 1 | PART 4 | FEBRUARY 2010

TRANSFER PRICING

- Transfer Pricing Landscape in India
- Transfer Pricing - Judicial Guidance Evolves
- Dispute Resolution Panel - An Alternate to Resolve Disputes
- Evolving Concepts in Resolving Transfer Pricing Disputes in India
- Withdrawal of Circular 23: Implications for Transfer Pricing Cases
- Your Queries on Transfer Pricing

EUROPEAN UNION

Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions

CHINA

China Targets Offshore Companies Making Indirect Equity Transfers of Chinese Companies

LANDMARK RULINGS

Rulings on Indo-UK/Indo-US & Indo-German Treaties

Transfer Pricing

- Merely because a comparable is making loss, it cannot be excluded from the list of comparables for the purposes of computation of arm's length price
- Lending or borrowing money between two associated enterprises comes within ambit of international transaction and whether same is at arm's length price has to be considered

Organisation for Economic Co-operation and Development (OECD)

Business and Industry Advisory Committee to the OECD (BIAC)

United States Council for International Business (USCIB)

In association with:

International Fiscal Association – USA Branch (IFA-USA)
International Tax Policy Forum (ITPF)
National Foreign Trade Council (NFTC)
Organization for International Investment (OFII)
Tax Council Policy Institute (TCPI)
Tax Executives Institute, Inc. (TEI)
Tax Foundation

7 June 2010
1:30 p.m. – 6:00 p.m. Meeting
6:00 – 7:30 p.m. Cocktail Reception

8 June 2010
8:00 a.m. – 5:00 p.m.

The Westin Washington, DC City Center
1400 M Street NW
Washington, D.C.

www.uscibtax.org

Save the Date June 7-8, 2010!

Featured Speakers:

Jeffrey Owens – Head of the Centre for Tax Policy & Administration (CTPA), OECD

Mary Bennett – Head of Tax Treaty, Transfer Pricing and Financial Transactions Division (TTP), OECD

Caroline Silberztein – Head of Transfer Pricing Unit, OECD

Jacques Sasseville – Head of Tax Treaty Unit, OECD

Senior U.S. Treasury and IRS Representatives

This conference provides a unique opportunity for the U.S. business community to interact with key representatives from the OECD Centre for Tax Policy and Administration and senior tax officials from the U.S. and other OECD countries. Panels will address current OECD tax projects and will include speakers from business, the OECD, and U.S. government.

Topics to be addressed include: Global Tax Administration Issues, Transfer Pricing – Intangibles, Transfer Pricing – The Future of the Arm's Length Principle, Tax Reform/Growth in OECD Countries, Information Exchange Issues of Interest to MNEs, Taxation and Development/Enlargement and Engagement Activities of the OECD, Secondment of Employees, and Tradable Permit Tax Issues. The program will provide ample opportunity for attendees to interact with key OECD officials.

Please note that there is a fee for this conference. Registration will begin in January/February 2010.

For more information, please visit **www.uscibtax.org**

Or contact Erin Breitenbucher at **ebreitenbucher@uscib-dc.org/202.682.7465**

A MONTHLY JOURNAL ON INTERNATIONAL TAXATION
International Taxation
FEBRUARY 2010

C O N T E N T S

INTERNATIONAL SCENARIO EUROPEAN UNION

439 Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions
- MICHAEL LANG

490 EU Tax Developments During 2009
- MAARTEN F. KOPER

CHINA

465 China Targets Offshore Companies Making Indirect Equity Transfers of Chinese Companies
- A.W. GRANWELL
- PENG TAO

UNITED STATES

472 U.S. Tax Developments During 2009
- CHARLES W. COPE

UNITED KINGDOM

483 UK Tax Developments During 2009
- DIANE HAY

MAURITIUS

499 Mauritius Update
- GARY GOWREA
- AVEENASH RAMTOHUL

INDIAN SCENARIO - TRANSFER PRICING

503 Transfer pricing landscape in India – A statutory update
- HASNAIN SHROFF
- A.PRADEEP

509 Transfer Pricing - Judicial Guidance Evolves
- MANOJ PARDASANI
- BHAVESH DEDHIA

513 Dispute Resolution Panel - An alternate to resolve disputes
- ROHAN K. PHATARPHEKAR
- A. PRADEEP

519 Evolving Concepts in Resolving Transfer Pricing Disputes in India
- VINAY NICHANI
- R. VIVEK DHARMA SANKARAN

530 Withdrawal of Circular 23: Implications for Transfer Pricing Cases
- S. P. SINGH
- SHIKHA GUPTA

537 Your Queries on Transfer Pricing
- MANOJ PARDASANI

Transfer pricing landscape in India – A statutory update

Hasnain Shroff* and **A.Pradeep****

The global economic downturn has confronted transfer pricing practitioners with a host of challenges. A recession that began in the United States at the end of 2007 morphed into a severe global contraction following the financial crisis of September 2008.[1] Historically, recessions associated with financial crises have been deeper, long lasting, and have been followed by slower recoveries than others.

Hasnain Shroff

A. Pradeep

In the above circumstances, many taxpayers across the globe had to deal with loss situations that rendered traditional approaches to transfer pricing at best difficult and at worst impossible, to apply. Tax authorities at the same time, recognizing the potential for income shifting to lower tax jurisdictions, are becoming more vigilant in enforcing transfer pricing regulations, including imposing strict penalties, new documentation requirements, increased information exchanges and increased audit and inspection activity.

Across the globe, there is a substantial increase in transfer pricing audits and disputes — India is no exception. The factors that have contributed to this phenomenon are: *(i)* mounting fiscal demands on the Governments; *(ii)* need to preserve tax base in a recessionary economic environment; *(iii)* constant competitive pressures to structure the business operations efficiently; and *(iv)* unprecedented collaboration between revenue authorities.

In the above scenario, the Indian Government introduced significant amendments relating to transfer pricing both in the Finance Act, 2009 and proposals in the Direct Taxes Code ('DTC'). This article provides a snapshot of the various amendments and proposals, background in which they were introduced, issues and challenges in implementation.

* Hasnain Shroff, Director, Global Transfer Pricing Services, BSR & Co.

** A. Pradeep, Senior Manager, Global Transfer Pricing Services, BSR & Co.

The views provided are personal. The authors could be reached at hshroff@kpmg.com and pradeepa@kpmg.com

1. Transfer Pricing Amendments brought out in the Finance Act, 2009

◆ *Safe Harbour Rules*

Transfer pricing disputes have been common in almost all industries but more so in the IT/ITES sector. Nasscom and several other industry bodies had been lobbying with the Indian Government for the need to provide some form of 'certainty' on pricing of international transactions and determination of arm's length margins based on risk profiling the enterprises as an attempt to perhaps eliminate or significantly reduce transfer pricing disputes.

The safe harbour rules intend to reduce the impact of judgmental errors in determining the transfer price. Safe harbour has been defined to mean 'circumstances' in which, the revenue authorities shall accept the transfer price declared by the taxpayer.

However, safe harbour rules are difficult to formulate due to the subjectivity involved in the identification and quantification of safe harbour. Application of safe harbour in some cases may not provide an equally corresponding arm's length result in the foreign tax jurisdiction thereby resulting in potential economic double taxation. Also, industry specific safe harbours may be considered as discriminatory and could face anti-competitive allegations.

Internationally, safe harbours have taken the form of stipulation of profit margins, thresholds for prescribed classes of transactions, specified activities and also providing for certain inter-company services to be rendered at cost without a mark up.

We expect the proposed safe harbour provisions to be in line with the international trends mentioned above with necessary variations in the Indian context. The Central Board of Direct Taxes (CBDT) would need to assess all the above factors before framing the provisions. Further, since the amendment is overdue and is applicable from tax year commencing 1st April, 2009, it needs to be seen how soon the CBDT notifies the rules for the taxpayers to adopt these safe harbours.

The introduction of safe harbour rules in India has further moved a step closer recently with the establishment of a committee[2] that would finalise details of the new provision. The committee, which is operated by the CBDT, will be made up of senior tax officials and representatives from trade and industry and is expected to soon meet to discuss the finer details of the provisions.

◆ *Variation from the Arm's Length Price*

The erstwhile mechanism under the proviso to section 92C(2) of the Act allowed a benefit of 5% variance from the arm's length price, at the option of the taxpayer. Various Tribunal rulings[3] in the past had confirmed the availability of a virtual 'standard deduction' of 5% from the arithmetic mean of comparable prices, at the option of the taxpayer.

With a view to resolve the controversy of varied interpretation, the Finance Act, 2009 was amended so that, if the variation between the 'price of the controlled transaction of the taxpayer' and 'the arm's length price' is not more than 5% (of the controlled transaction of the taxpayer), the former would be deemed to be at arm's length. The amendment now restricts the adjustment only to those cases which fall within the ± 5% variance range. Those cases falling outside the range shall no longer be eligible for the benefit as the option clause has now been omitted.

The other change is that the 5% range is now to be applied to the transfer price of the taxpayer rather than on the arm's length price. Though the aim of making the change was to restrict the conflicting interpretation of the proviso to section 92C(2) taken by taxpayer and revenue authorities, the changes proposed have actually made the proviso favourably inclined to the revenue authorities.

The impact of the amendment is illustrated in the table below :

Particulars	Scenario Erstwhile	 Amended
Arm's Length price (given)	120	120
Less – Mark Up (5 per cent)	6	
Adjusted ALP	114	115.5
International Transaction Value	110	110

Particulars	Scenario Erstwhile	Amended
Adjustment		
As per revenue authorities	10	10
As per Taxpayer	4	10

The proviso in the Act has been amended with effect from 1st October, 2009. An issue that is currently being debated is whether the proviso would apply for cases relating to assessment year 2010-11 and onwards or does it apply to all open assessments as on 1st October, 2009. The revenue based on the memorandum explaining the provisions of Finance Bill, 2009, would be keen to apply this amendment to all open assessments pending before the transfer pricing officer as on 1st October, 2009. However, such a position would raise a question as to whether there can be a different definition in law at the time of preparation of transfer pricing documentation by the taxpayer versus that at the time of its scrutiny by the revenue authorities.

It would have been better that India adopted the concept of inter-quartile range in place of arithmetic mean. Many developed countries follow the 'arm's length range' concept, which, apart from being endorsed by the OECD guidelines, recognises the fact that in commercial dealings, independent enterprises could transact at a range of values and price points, all of which would be at arm's length.

Using the approach of an arm's length range would provide greater certainty for taxpayers as compared to the approach of arithmetical mean currently being followed and, accordingly, such inter-quartile range can serve as an alternative to the application of the arithmetical mean. Further, this will also lead to a considerable reduction in transfer pricing litigation.

- ***Alternate Dispute Resolution Panel***

Since its inception into Indian law, transfer pricing has been one of the most litigated issues in the Indian tax scenario with a number of issues still pending resolution. To facilitate the expeditious resolution of transfer pricing disputes in a fast track mode, the mechanism of Dispute Resolution Panel ('DRP') has been introduced. A brief summary of the alternate dispute resolution system is provided below :

- Only those taxpayers subject to a transfer pricing adjustment made by *(i)* the transfer pricing officer, or *(ii)* a foreign company, would be eligible to present their case before the DRP.
- The DRP would be set-up by the CBDT and would comprise of three Commissioners of Income-tax.
- When a transfer pricing officer determines the arm's length price of a taxpayer's international transactions, he passes an order proposing to make an adjustment to this effect. Such an order of the TPO is then forwarded to the Assessing Officer, who would have to prepare a draft assessment order.
- The draft assessment order would then be forwarded to the taxpayer for giving his acceptance or objections. Should the taxpayer choose to accept the draft order, the Assessing Officer would pass a final assessment order giving appropriate effect.
- If the taxpayer chooses to raise an objection against the draft order, he would file a copy of his reply before the DRP within 30 days of receipt of the order. The DRP would then consider the facts of the case, the objections raised by the taxpayer, other relevant information and pass a directive to the tax officer.
- The directive would contain the decision of the DRP and instructions to the Assessing Officer for concluding the final assessment. While doing so, the DRP would grant the taxpayer and/or the Assessing Officer an opportunity of a personal hearing. The proposed provisions also allow a maximum time of 9 months from the end of the month in which the draft order is made available to the taxpayer.
- The salient feature being that only the taxpayer may appeal against an order passed in line with the guidance of the DRP. In other words, the direction issued by the

DRP is binding on revenue. Since there would be no final assessment order from the tax officer till the case is not disposed by the DRP, the tax demand would automatically be in abeyance.

Constitution of Dispute Resolution Panel - The CBDT notified the rules to regulate the procedure of the DRP. The rules came into effect from 20th November, 2009. Under the said rules, DRPs have been constituted at eight cities in India, namely Delhi, Mumbai, Ahmedabad, Kolkata, Chennai, Hyderabad, Bengaluru and Pune.

The Rules also provide for the procedure for filing objections, details to be provided for each objection, manner of submitting additional evidences, etc.

The DRP is a very significant initiative and is conceptually a step in the right direction with an intent for a speedy and consistent disposal of disputes. However, the key remains with the ground-level action and one would have to wait and watch the implementation of these key amendments.

2. Overview of Transfer Pricing Proposals in the Draft of the Direct Tax Code

On 12th August, 2009, India's Finance Minister released a draft of the DTC which, if enacted, would replace the existing Income-tax Act, 1961. The aim of the DTC is to improve the efficiency and equity of tax legislation in India, introduce moderate levels of taxation, expand the tax base, simplify the language to enable better comprehension and remove ambiguity to foster voluntary compliance.

The changes proposed would be effective from 1st April, 2011, subject to deliberations in industry and professional forums before going through the motions in the Parliament. The DTC has proposed these key changes for transfer pricing regulations :

- ***Advance Pricing Agreement ('APA')***

In transfer pricing jurisdictions of several developed countries, upfront negotiations through APAs are preferred to protracted litigation. An APA is a formal, negotiated agreement with the tax authority of either the home country (unilateral) or another/many countries involved in the inter-company transaction (bilateral or multilateral) that identifies the transfer pricing method to be used for the identified transactions for some number of future years.

Such an agreement would be binding on the taxpayer and the tax authorities. The arrangement is generally valid for a specified period on the premise that the facts and conditions, based on which the agreement has been passed, would not undergo a change.

The DTC defines an APA as an agreement between a taxpayer and the tax authorities for an 'upfront' determination of the arm's length price in relation to international transactions. The CBDT has been authorized to enter into APAs in respect of the arm's length price with the taxpayer regarding the taxpayer's international transactions.

The determination of the arm's length price would be based on prescribed methods and subject to any necessary adjustments. The APA would be valid for a period of up to five financial years, unless there would be a change in the law or facts. The arm's length price, once determined by an APA, would not be subject to amendment by other provisions of the proposed Code. An APA would be binding on both the taxpayer and the tax authorities.

The introduction of APAs is a welcome measure and should provide a fair degree of certainty to business transactions, given the state of transfer pricing litigation in India. The challenges nonetheless will be in the timely disposal of APA applications and the flexibility and willingness shown by the authorities to dispose of complex applications.

- ***Anti-Avoidance Measures***

Transactions having a principal purpose of obtaining a tax benefit that would create rights or obligations contrary to the arm's length principle would be considered to be "impermissible avoidance arrangements."

These arrangements would be covered by the anti-avoidance measures. The new anti-avoidance rules will have a treaty override. Such arrangements would be disregarded, combined, or re-characterized (either in whole or part), with the tax consequences determined accordingly.

◆ ***Thin Capitalization and presumption of purpose***

The DTC Bill has introduced the concept of thin capitalization, in a limited manner, by allowing the re-characterization of debt as equity (and *vice-versa*) in situations of "impermissible avoidance arrangements". Such re-characterization could be triggered under circumstances where the arrangement among parties is *(i)* not at arm's length, or *(ii)* lacks commercial substance, or *(iii)* adopt means that are ordinarily not adopted for *bona fide* purposes.

An arrangement (either in whole or in part) would be presumed to have been entered into for the purpose of obtaining a tax benefit unless the person obtaining the tax benefit could prove that obtaining the tax benefit was not the principal purpose of the arrangement. Such arrangements may be scrutinised with a view to disregard its "form" and consider the underlying "substance" of the arrangement for taxation.

The new proposed thin-capitalisation provisions are now becoming a significant area of concern and evaluation for multinational enterprises operating in India to review their respective capital structures and identify appropriate and acceptable benchmarks. The presumption-of-purpose provisions put the onus entirely on the taxpayers to prove their merit, in the absence of which they could be held guilty. Though the effective date for these new regulations is set in April 2011, changing capital structures is a time-consuming process often requiring significant cash flow movements, or regulatory approvals, or both.

◆ ***Safe Harbour and Dispute Resolution***

The existing provisions incorporated in Budget 2009 relating to safe harbour and DRP have been retained. One key difference between the provisions of the DRP as it stands now and that proposed in the DTC is that whilst all cases where the tax officer is proposing a variation can be referred to the DRP, the DTC provides for reference of cases only where the proposed variation is greater than INR 2.50 million.

◆ ***Associated Enterprises: Expanded Scope***

The definition of associated parties has been modified to omit the reference of direct or indirect participation in management, control or capital. The definition now seeks to illustrate directly the relationship between two associated enterprises. The following changes have been proposed :

Criteria	Proposed threshold	Existing threshold
Shareholding with voting power	10%	26%
Loan to assets ratio	26%	51%
Nomination of Directors	One third	One half
Purchase/supply of raw material and consumables	Two thirds	90%

The above proposed changes would widen the scope of transfer pricing compliance and would also bring into its ambit, transactions with strategic or financial investors.

◆ ***Audit Process***

- A report of international transactions, as certified by a Chartered Accountant, would have to be filed directly with the Transfer Pricing Officer instead of the Assessing Officer.
- The selection of cases for scrutiny by a Transfer Pricing Officer would be based on a risk management strategy framed by the CBDT; however, that strategy or criteria would not be made public.
- The draft legislation would repeal a requirement that certain conditions must be satisfied before adjustments could be made by a Transfer Pricing Officer.

Presently, all cases more than a specified monetary limited are being selected for audit. The selection of cases based on a risk management strategy is as per global best practices and ensures that revenue focuses on specific cases.

- ***Change in Due Dates***
  - The report of international transactions, as certified by a Chartered Accountant, would have to be filed by 31st August of the following financial year.
  - The time-limit for selection of cases by the Transfer Pricing Officer is proposed to be within two months from the end of the financial year in which the accountant's report has been filed.
  - The transfer pricing audit would have to be completed within a 42-month period (determined by reference to the end of the financial year in which the international transactions were undertaken).
- ***Penalty Provisions***

Also, to support a strong preclusion programme in a moderate tax regime, penalties on non-conformance are sought to be equalised by the DTC. The changes to the applicable penalty amounts are as below :

Reason	Penalty Amount	
	Proposed	Existing
Adjustment to taxpayer's income	100% to 200% of tax on adjustments	100% to 300% of tax on adjustments
Failure to maintain documentation	Rs. 50,000 to Rs. 2,00,000	2% of value of transaction
Failure to furnish report of international transactions	Rs. 50,000 to Rs. 2,00,000	Rs. 1,00,000
Failure to furnish documentation	Rs. 5,000 to Rs. 1,00,000	2% of value of transaction

Conclusion

The Code seeks to give significant powers to the tax authorities. It remains to be seen how ready Corporate and the tax administration are to accept these changes in their entirety. We believe that the proposed Code will undergo some changes before it is seen in the final form.

Implementation of the above changes will mark the maturity of the transfer pricing regime in India. Amendments like introduction of APAs, Dispute Resolution Panel and rationalisation of penalties are sure signs of an equitable transfer pricing regime.

The directions to be issued by the newly constituted DRP over the next few months would go a long way to establish the trust among the investors on the initiatives of the Government towards transfer pricing dispute resolution and establish an investor-friendly climate.

1. International Monetary Fund, "World Economic Outlook 2009 – Crisis and Recovery," April 2009, Chapter 1.
2. www.tpweek.com in an article titled "Indian safe harbour rules one step closer", dated January 13th, 2009.
3. *Development Consultants (P.) Ltd.* v. *DCIT* [2008] 23 SOT 455; and *Philips Software Centre (P.) Ltd.* v. *Asstt. CIT* [2008] 26 SOT 226 (Bang.).

Dispute Resolution Panel - An alternate to resolve disputes

Rohan K. Phatarphekar* and **A. Pradeep****

Rohan K. Phatarphekar

A.Pradeep

Albert Einstein once admitted that, "The hardest thing in the world to understand is the income-tax". Most of the multinationals operating in India would not in unison particularly when the fundamentals of international taxation are subject to unique interpretation and application in India on a regular basis.

Foreign companies in India need to deal with complex issues around attribution of profits to permanent establishment, tax treaty issues, withholding taxes, expatriate taxation and above all transfer pricing appears to be on the top of their chart.

The disillusionment and frustration of multinational companies in India over the exceptional delay in dispensation of justice today looms large as a great threat to erode the investments and the confidence in the judicial system of the country.

Therefore, evolution of new juristic principle for dispute resolution has become imperative. Taking cognizance of this, the Government of India has introduced an Alternate Dispute Resolution Mechanism in the previous budget with the stated objective being speedy resolution of tax and transfer pricing disputes to provide certainty to multinationals.

Why special focus on transfer pricing disputes?

For both the tax administration and the taxpayer, transfer pricing cases can present unique challenges as they are fact-intensive and may involve difficult evaluations of comparability, economic and market conditions, financial and other industry informations. Consequently, there are a number of assumptions involved in the determination of the arm's length price.

Since the introduction of transfer pricing legistlation in India, five rounds of revenue audits have been completed. Each year has seen a steep increase in the quantum of adjustment with the latest assessment year (A.Y. 2006-07) resulting in a 10,000 crore[1] adjustment for about estimated 800 cases.

* Rohan K. Phatarphekar, Executive Director and National Head, Global Transfer Pricing Services, KPMG India.

** A. Pradeep, Senior Manager, Global Transfer Pricing Services, BSR & Co.

The views provided are personal.

TRANSFER PRICING AUDIT STATISTICS (ESTIMATES)

Particulars	2002-03	2003-04	2004-05	2005-06	2006-07
No. of cases selected for scrutiny	1081	1501	1768	1479	1600
No. of cases adjustment	236	345	477	370	800
% of cases adjusted	22	23	27	25	50
Amount of Adjustments (INR Cr.)	1403	2631	3947	5060	10000

Also, since there is no time-limit for completion of first level appellate proceedings [*i.e.*, at the CIT(A)] cases have been stagnating for long periods. Further, even if cases reached the level of the Income Tax Appellate Tribunals (ITAT), we see many instances where the case is remanded back to the Assessing Officer for fresh analysis.

This facet is illustrated by the fact that as on 25th April 2008, there were approximately 70,000 applications[2] and petitions pending before the various ITATs dispersed across in India.

The Government proposes to rectify this situation through the alternate dispute resolution mechanism. This is in line with international best practices where more reliance is placed on negotiation and other alternate dispute resolution mechanisms to resolve disputes rather than to litigate.

Global trends on Alternate Dispute Resolution Mechanisms

Alternate dispute resolution mechanisms can be broadly divided into two categories namely, adjudicatory and non-adjudicatory. The adjudicatory procedures such as arbitration lead to a binding ruling that decides the case. The non-adjudicatory procedures such as negotiation, mediation and conciliation result in resolution of disputes by agreement of the parties without adjudication.

A brief look at the international scenario of Alternate Dispute Resolution Mechanisms (ADRM) reveals the popularity of its usage in various countries. The seeds of ADRM in the UK can be traced to the work of the advisory, conciliation and arbitration service which was formed way back in 1974. In the US, the IRS has in recent years brought out two mainstream ADRMs that are available to all taxpayers, one for non-binding mediation and one for binding arbitration.

In China and Japan, mediation was used as primary means of conflict resolution. The Chinese principle was the effect of Confucian view of harmony and dispute resolution by ethics and morals rather than coercion. The increasing caseloads in the traditional courts and the probabilities of lesser cost and time have made ADRMs popular.

In India, ADRM have been present in various civil laws such as Lok adalats, Panchayats, and Consumer redressal forums. In Indian income-tax laws, various forms of ADRM include: Mutual Agreement Proceedings, Authority for Advance Ruling, Settlement Commission and the proposed Advance Pricing Agreement mechanism. However, the implementation and success rate of the present mechanisms is not very encouraging.

Key features of Dispute Resolution Panel ('DRP')

The DRP mechanism provides for the pre-assessment screening of proposed draft assessment order by a collegium of three Commissioners without impairing the right to legal remedy for a taxpayer by way of normal appeal procedure on a question of fact to the ITAT and on law to the High Court.

In case of an adjustment to an eligible taxpayer (where an adverse order is proposed for a foreign company or a transfer pricing adjustment by the transfer pricing officer for any other taxpayer), the Assessing Officer will need to issue a draft assessment order.

The taxpayer may file his objections on the draft assessment order (in Form 35A) with the DRP and with a copy to the Assessing Officer within a period of 30 days of receipt of the same. If a taxpayer has been subject to a transfer pricing adjustment and also has some corporate tax adjustments to which it objects, both objections must be presented together to the DRP.

The DRP mechanism is applicable in cases where an adjustment/variation are made on or after 1st October, 2009 in respect of any eligible taxpayer.

DRP Collegium

Two members of the DRP are the Commissioners of Income-tax of the relevant jurisdiction and the Third Member is a Director of International Taxation from another jurisdiction. The DRP collegium have vast powers to hear the case, call for additional evidences and witnesses and then provide guidance to the Assessing Officer for preparing the final order. The DRP is given powers under section 131 of the Income-tax Act, 1961 (the Act), as are available to a Court under the Civil Procedure Code, 1908.

To ensure impartiality in adjudication of transfer pricing disputes, the Central Board of Direct Taxes (CBDT) has decided that Commissioners associated with transfer pricing orders will not be a part of the DRP collegium. According to the rules, DRP panels is set up in eight cities – Delhi, Mumbai, Ahmedabad, Kolkata, Chennai, Hyderabad, Bangalore and Pune and additionally to be established at the discretion of the CBDT based on the territorial workload and efficiency.

A practical challenge could be since the entire panel is to be present at the time of hearing, each time a member is transferred, a notification to amend the panel will have to be issued and the taxpayer will need to represent the case once again.

DRP Rules

The Central Board of Direct Taxes (CBDT) has issued Income-tax (Dispute Resolution Panel) Rules, 2009, *vide* Notification No. 84/2009 [S.O. 2958(E)/ F. No. 142/22/2009-TPL], dated 20th November, 2009.

The rules, *inter alia*, contain provisions relating to constitution of the panel, procedure for filling objections, hearing of objections, power to call for or permit additional evidence, Issue of directions, passing of assessment order, rectification of mistake and appeal against assessment order.

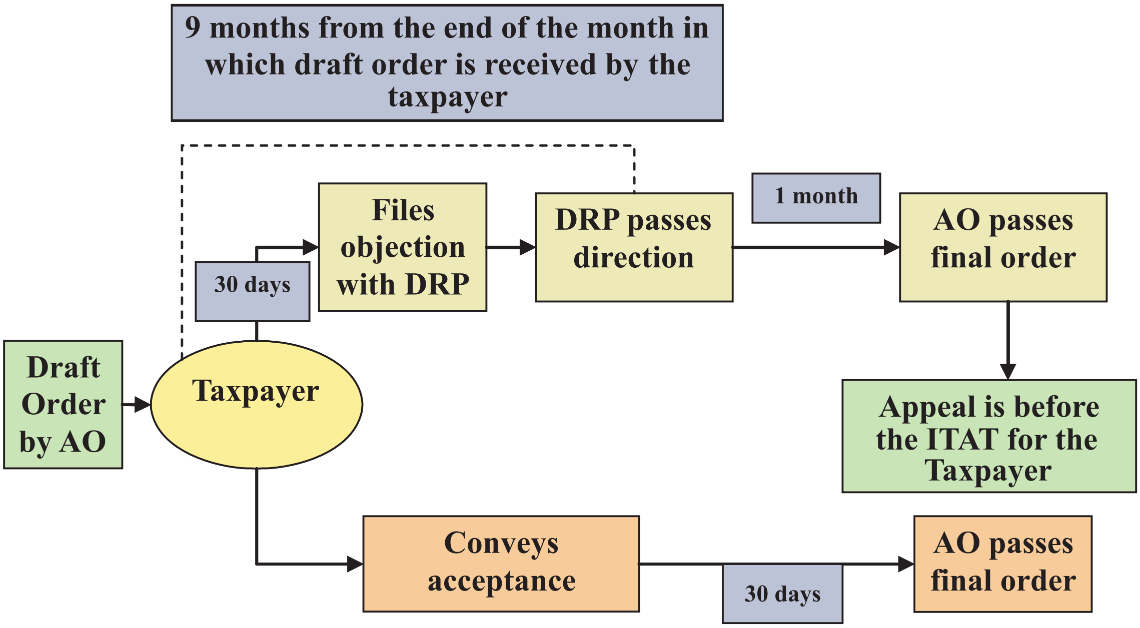
Key benefits

DRP cannot set aside proposed variation and has to decide the issue. The DRP is mandated to complete its proceedings within a period of 9 months from the end of the month the draft order is received by the taxpayer.

The most significant provision being that only the taxpayer may appeal against an order passed in line with the guidance of the DRP; the direction issued by the DRP is binding on revenue. Also to that extent there would not be a tax demand on the taxpayer until the final order is issued based on the directions of the DRP.

Interestingly, even though the DRP procedure is with respect to orders passed by the Assessing Officer from 1st October, 2009, there have been two cases[3] wherein the Apex Court in India has directed the department to refer the case to the specialist DRP. The decision by the Apex Court to refer past transfer pricing cases to the DRP while it is just being constituted signifies the importance of the DRP mechanism.

DRP PROCEDURE SNAPSHOT



Preparing objections, submission and representation before the DRP

The format for filing objections with the DRP has been notified in the Income-tax (Dispute Resolution Panel) Rules, 2009. The form is exhaustive, with the following to be detailed for each ground of objection.

- *Facts as submitted to Assessing Officer and as modified by Assessing Officer;*
- *Reasons, pointing the specific fact or facts modified by Assessing Officer with which taxpayer does not agree, if any;*
- *Legal arguments submitted to Assessing Officer;*
- *Case laws relied upon by the taxpayer;*
- *Legal argument relied upon by Assessing Officer; Case laws relied upon by Assessing Officer;*
- *Any additional new case laws which the taxpayer may like to rely upon; and*
- *Factual and legal arguments against the addition proposed by Assessing Officer.*

However, taxpayers are to note that to raise any additional ground which has not been set forth in the objections, a separate affidavit would be required. Similarly, during the course of proceedings, the DRP has power to call for or permit additional evidence.

Considering the number of cases to be disposed by the DRP within the stipulated period, there would be significant pressure to complete the proceedings and there may be limited opportunity for personal hearing with the DRP. It is, therefore, necessary that the taxpayer strategies his defence and puts forth all the legal and factual arguments in detail at the earliest opportunity.

Debatable issue - Is DRP the only route before proceeding to the ITAT?[4]

One issue that has generated considerable debate has been whether the DRP route is mandatory. Since the notes to clauses and the Finance Minister's budget speech use the term "alternative dispute resolution mechanism", there could be a view that the DRP route is an option of the taxpayer and the taxpayer could opt to be governed by the normal appeal proceedings, *i.e.*, the CIT(A) route.

It is important to refer to an erstwhile section 144B (omitted w.e.f. 1st April, 1989) where a similar set of provisions existed. There has been significant litigation with respect to these provisions and the principle that emerged from the decisions[5] was that even if the taxpayer failed to file or had filed the objections after the prescribed time-limit, he is not restrained from making an appeal before CIT(A) for the order passed by Assessing Officer under section 143(3) of the Act.

Relying on these decisions perhaps it is possible to argue that the provisions of section 144C are not mandatory and an appeal can be filed under section 246A of the Act.

However, this position could be litigative. Further, the revenue seems to be of the view that DRP route is mandatory and right to appeal may not be available later in case the taxpayer does not file objections with the DRP.

Challenges to the Government

To ensure the success of this mechanism, there are quite a few challenges before the Government, which need to be addressed in a practical and judicious manner

Burden on the panel*:* Eight panels have been notified till date, considering the significant number of cases, the strain on resources and time will be significant. Further, the role of the DRP panelists is in addition to the normal role being currently held by them. Also, all three Commissioners need to be present for the DRP hearings. Since there is no minimum limit for reference to the DRP even minor issues may need to be presented to the DRP.

Such extraordinary burden should not result in a situation where adequate time for analysis of complex issues is not provided. The onus is also on the taxpayer to provide appropriate submissions and representing in a manner so as to enable the DRP to provide the directions without unnecessary delays.

Trained Panel to adjudicate - DRP would be dealing with complex issues such as losses during recession, payouts such as royalty, issues around intangibles, etc. What is important is that the Commissioners nominated for the panel must have a strong level of knowledge and familiarity, on both technical and economic grounds, in dealing with transfer pricing issues on cross-border transactions.

Revenue objective - One of the perceived shortcomings in the dispute resolution process is the independence of the panel in resolving the dispute. Since some of the panel members will also be indirectly responsible for revenue collection from the concerned taxpayers, it needs to be seen how much intent would be present to resolve the dispute.

Considering that the tax demand cannot be enforced till the final order is passed, it is estimated that the Government's tax collections could take a Rs. 10,000 crore[6] dent during the year. Globally and recently in India, transfer pricing has become one of the key tools for increasing direct tax collections. In the latest CBDT Press Release dated, 8th January, 2010, it is mentioned that the Department will leave no stone unturned to achieve the revised direct tax target of Rs. 4 lakh crore.

The administrators should keep in mind that free cross-border flow of capital is in the larger interest of the economy and the fiscal laws thereby should be an instrument rather than a drawback on the economic development of our country. Steps to increase tax base, mechanisms for better collection with greater expedition are better tools to augment revenue.

Conclusion - Is the DRP enough?

Abraham Lincoln on the philosophy of Alternate Dispute Resolution systems declared that "discourage litigation; persuade your neighbours to compromise whenever you can. Point-out to them how the normal winner is often a loser in fees, expenses, cost and time."

The DRP is a significant initiative and is conceptually a step in the right direction with the intent for a speedy and consistent disposal of disputes. However, the key lies in the ground-level action and the DRP should strive to function with an objective to resolve and not to perpetuate the dispute.

Incidentally, the proposed Direct Taxes Code seeks to expand the role of the DRP and extend the coverage thereof to all taxpayers where the proposed adjustment exceeds Rs. 25 lakhs. Clearly, it is of paramount importance that the tax department gets it right, given the opportunity that this route offers to reduce tax litigation and thereby attract more investments.

However, creation of the DRP cannot be considered as the panacea to remove all the litigation. What is inherent in the regulation needs to be clarified and there is greater need to bring in guidance on contentious issues. These include *(i)* use of multiple year data; *(ii)* economic and risk adjustments to the comparable data; *(iii)* usage of contemporaneous data; *(iv)* use of foreign comparables; *(v)* use of secret comparables; *(vi)* preference of transaction specific approach by revenue authorities over an aggregated approach, etc. The regulators should pragmatically consider that harmonising the provisions of the law as well as its language with the accepted global norms should reduce the scope for controversies.

In addition to the DRP, the Government has introduced safe harbour provisions and this mechanism is expected to be finalised soon. Also, it is expected that the risk based assessment system and the advance pricing agreement program could get fast tracked and be introduced in the forthcoming budget instead of waiting for implementation of the Direct Taxes Code in entirety. All of the above are steps in the right direction.

1. The *Economic Times* in an article "800 Cos. slapped with Rs. 10k cr. transfer pricing demand"dated 11th December, 2009.
2. The Financial Express in an article titled "70,000 income-tax cases pending across India" dated 26th April, 2008.
3. SC - *ACIT* v. *Kamla Dials & Devices Ltd.* [SLP-CC 10495/2009]; *ACIT* v. *HCL Technologies Ltd.* (SLP-CC 10920/2009).
4. The Central Board of Direct Taxes, on January 20, 2010, has issued a clarificatory letter to specify that DRP route is entirely optional and is the choice of the taxpayer.
5. *CIT* v. *Satya Narain* [1998] 229 ITR 477 (Punj. & Har.); *Nagpur Zilla Krushi Audyogik Sahakari Sangh Ltd.* v. *Second ITO* [1994] 207 ITR 213 (Bom.); *Indian Aluminium Co. Ltd.* v. *CIT* [1986] 162 ITR 788 (Cal.).
6. Business Standard in an article titled "Disputes panel may cause an Rs. 10,000 cr. dent in revenue" dated 31st December, 2009.