

### **D.3. Transfer Pricing Practices and Challenges in India**

#### **D.3.1. Introduction**

D.3.1.1. Transfer pricing provisions were introduced in the Indian Income-tax Act in 2001. The provisions were broadly aligned with the OECD guidelines on transfer pricing. Over the last 15 years, transfer pricing audits in India have thrown up a number of issues and challenges. Administration of the transfer pricing law has also resulted in a number of disputes and protracted litigation. With a view to reducing transfer pricing disputes, a number of initiatives have been introduced by the tax administration in the recent past. Some of the initiatives have included the introduction of an Advance Pricing Agreement (APA) Scheme, inclusion of Safe Harbour provisions, utilisation of the MAP provision in bilateral tax treaties to resolve TP disputes, migration from a quantum of transaction based selection to risk-based selection of TP cases for audit, and issuance of various Circulars and Instructions on transfer pricing matters to provide clarity on TP issues, etc.

D.3.1.2. Due to these initiatives, there has been an impact on the number of cases under audit as well as the number of disputes arising from such audits which have both shown a downward trend. Transfer pricing tax administration can now focus on high risk cases and at the same time provide a reasonable degree of certainty to low risk taxpayers. The new approach is expected to raise the quality of transfer pricing audits without creating an environment of tax uncertainty and protracted litigation.

D.3.1.3. India, as a member of the G-20, has participated in the Base Erosion and Profit Shifting (BEPS) Project on an equal footing with the OECD and other non-OECD member countries and is a party to the consensus developed under the various Action Points of the BEPS Project. The final reports of all the 15 Action Points of the BEPS Project have been endorsed at the highest political level by all G-20 countries, including India. Accordingly, India is committed to implementing all the recommendations contained in the BEPS reports including those on transfer pricing.

D.3.1.4. In subsequent paragraphs of this sub-chapter, various aspects pertaining to the transfer pricing regime in India and the outstanding issues that continue to pose challenges to the transfer pricing administration are discussed.

#### **D.3.2. Transfer Pricing Regulations in India**

D.3.2.1. The Indian Transfer Pricing Regulations are based on the arm's length principle. The regulations came into effect from 1 April 2001. The regulations provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price (ALP). The concept of associated enterprises has been defined in detail in the regulations.

D.3.2.2. The ALP is to be determined by any of the prescribed methods. The methods prescribed for the determination of an arm's length price are: Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method, Profit Split Method and a residual method known as "any other method" to determine the arm's length price under the statute. The regulations do not provide any hierarchy of the methods and support the concept of the "most appropriate method" which provides the most reliable measure of an arm's length result under a particular set of facts and circumstances.

D.3.2.3. The regulations prescribe mandatory annual filing requirements as well as maintenance of contemporaneous documentation by taxpayers if international transactions between associated enterprises cross a threshold, and they contain penalty implications in case of non-compliance. The primary onus of proving the arm's length price of a transaction lies with the taxpayer. In most cases, the Indian entity is taken as the tested party and Indian comparables are used. If the foreign associated enterprise is the lesser complex entity it is taken as the tested party.

D.3.2.4. In order to provide uniformity in the application of transfer pricing law, there are specialised Commissionerates under the supervision of a Principal Chief Commissioner of Income-tax (International Taxation) at Delhi and two Chief Commissioners of Income-tax (International Taxation) stationed at Mumbai and Bengaluru. Transfer Pricing Officers (TPO) are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, on-the-spot enquiry/verification and compelling the production of books of account and other relevant documents during the course of a transfer pricing audit. The mechanism of the dispute resolution panel (DRP) is also available to taxpayers to resolve disputes relating to transfer pricing.

D.3.2.5. The government of India has a dedicated website which contains comprehensive information about the latest provisions of tax law and related rules, Circulars and Instructions including on transfer pricing. The website has a user friendly interface. It can be accessed at <http://www.incometaxindia.gov.in>

### **D.3.3. Transfer Pricing Issues in India**

#### **D.3.3.1 . Comparability Analysis**

Comparability analysis is the key to determining the arm's length price of an international transaction. However, increased market volatility and increased complexity in international transactions have thrown open serious challenges to comparability analysis and determination of the arm's length price. Some of these challenges and the responses of the Indian transfer pricing administration in dealing with these challenges are analysed below.

**D.3.3.2. Use of contemporaneous data:** Use of contemporaneous data of comparable companies provides a more accurate arm's length price in a particular year. Accordingly, the Indian transfer pricing rules gave primacy to the data of the current year, i.e., the year under audit.

**D.3.3.3. Application of data rules:** As stated above, the Indian transfer pricing regulations stipulated that data to be used in analysing the comparability of the uncontrolled transaction with an international transaction should be the data relating to the financial year in which the international transactions have been entered into. However, the rule also provided an exception and permitted the use of data for the preceding two years if it was proved that such data could have an influence on the determination of the arm's length price. This exception resulted in numerous disputes and protracted litigation between taxpayers and the tax authorities. To put an end to such disputes and to provide the taxpayers a degree of flexibility to defend their transfer prices, the Indian Government decided to permit the use of multiple-year data. Thus, for transactions undertaken on or after 1st April 2014 (i.e., from Assessment Year 2015-16), multiple year data of the comparables can be used for the purpose of benchmarking international transactions with associated enterprises.

#### **D.3.4. Issues relating to Risks**

**D.3.4.1.** A comparison of functions performed, assets employed and risks assumed is the basis of any comparability analysis. Indian practice has been to evaluate risk in conjunction with functions and assets. India believes that it is unfair to give undue importance to risks in determination of the arm's length price in comparison to functions performed and assets employed.

**D.3.4.2.** Identification of risks and of the party which bears such risks are important steps in comparability analysis. India believes that the conduct of the parties is key to determining whether the actual allocation of risks conforms to contractual risk allocation. Allocation of risks depends upon the ability of parties to the transaction to exercise control over such risks.

Core functions, key responsibilities, key decision-making and levels of individual responsibility for the key decisions are important factors to identify the party which has control over the risks. Besides, financial capability to bear the risk is also important in establishing whether a party actually bears or controls the risk.

D.3.4.3. In India, MNEs make claims before the transfer pricing officers that related parties engaging in contract R&D or other contract services in India are risk-free entities. Accordingly, these related parties are said to be entitled to only routine (low) cost plus remuneration. MNEs also contend that the risks of R&D activities or services are being controlled by them and Indian entities being risk-free entities are only entitled to low cost plus remuneration.

D.3.4.4. The notion that risks can be controlled remotely by the parent company and that the Indian subsidiary engaging in core functions, such as carrying out research and development (R&D) activities or providing services, is a risk free entity has not been found acceptable. India believes that in many cases the core function of performing R&D activities or providing services is located in India, which in turn requires important strategic decisions to be taken by the management and employees of the Indian subsidiaries. These strategic decisions could be in terms of designing the product or the software; the direction of R&D activities or providing services; and the monitoring of R&D activities. Accordingly, the Indian subsidiary exercises control over the operational and other risks. In these circumstances, the ability of the parent company to exercise control over the risks remotely from a place where core functions of R&D and services are not located is very limited.

### **D.3.5. Arm's Length Range**

4.5.1. In order to align the Indian transfer pricing law to the best international practices, the law was amended recently to introduce a 'Range' concept for determining the ALP, which is applicable for international transactions undertaken on or after the 1<sup>st</sup> April 2014 (i.e., effective from assessment year 2015-16). The salient features of the 'Range' concept are as follows:

- A dataset of the results/profit margins of six or more comparable companies are to be arranged in an ascending order and an arm's length range beginning with the thirty-fifth percentile of the dataset and ending with the sixty-fifth percentile of the dataset (the "Middle 30" of the dataset) is to be constructed;
- If the price at which the international transaction has actually been undertaken is within the range referred to above, then the price of the transaction shall be deemed to be the arm's length price;

- If the price at which the international transaction has actually been undertaken is outside the range referred to above, then the arm's length price shall be the median of all the values included in the dataset (i.e. the 50th percentile);
- However, if the range is not used due to the non-availability of at least six comparable companies, the arithmetic mean shall continue to be used to determine the ALP.

### **D.3.6. Comparability Adjustment**

As with many other countries, the Indian transfer pricing regulations require “reasonably accurate comparability adjustments”. The onus to prove a “reasonably accurate comparability adjustment” is on the taxpayer. The experience of the Indian transfer pricing administration indicates that it is possible to provide capacity utilisation and working capital adjustments. However, the Indian transfer pricing administration finds it difficult to make risk adjustments in the absence of any reliable, robust and internationally agreed methodology to provide risk adjustment.

### **D.3.7. Location Savings**

D.3.7.1. The concept of “location savings”, i.e. cost savings in a low-cost jurisdiction such as India, is one of the aspects taken into account while carrying out comparability analysis during transfer pricing audits. The expression “location savings” has a much broader meaning; it goes beyond the issue of relocating a business from a “high-cost” to a “low-cost” location and relates to any cost advantage that a jurisdiction can provide. MNEs continuously search for options to lower their costs in order to increase their profits. In this respect, India provides various operational advantages to the MNEs, such as availability of low-cost labour or skilled employees, lower raw material cost, lower transaction cost, reasonably priced rental space, lower training costs, availability of infrastructure at a lower cost, various direct and indirect tax incentives, etc.

D.3.7.2. In addition to the above cost advantages, India provides the following Location-Specific Advantages (LSAs) to MNEs:

- Highly skilled, specialised and knowledgeable workforce;
- Access and proximity to large and growing local/regional markets;
- Large customer base with increased spending capacity;
- Superior information networks;
- Superior distribution networks;
- Various policy incentives; and
- Market premium.

D.3.7.3. The incremental profit from LSAs is known as “location rents”. The main issue in transfer pricing is the quantification and allocation of location savings and location rents

among the associated enterprises. Using an arm's length pricing approach, the allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. It is possible to use the Profit Split Method to determine arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), and the bargaining power of the parties (which at arm's length would be determined by the competitiveness of the market, availability of substitutes, cost structure, etc) should both be considered as appropriate factors.

D.3.7.4. However, in situations where comparable uncontrolled transactions are available, the comparability analysis and benchmarking by using the results/profit margins of such local comparable companies will determine the arm's length price of a transaction with a related party in a low-cost jurisdiction. If good local comparables are available, the benefits of location savings can be said to have been captured in the ALP so determined. However, if good local comparables are not available that could capture the benefits of location savings or where the overseas associated enterprise (AE) is chosen as the tested party, the issue of capturing the benefits of location savings would remain an issue in determining the ALP.

### **D.3.8. Intangibles**

#### **General**

D.3.8.1. Transfer pricing of intangibles has been a difficult area of work for tax administrations across the world. The situation has been same for the Indian tax administration. The pace of growth of the intangible economy has opened up new challenges to the arm's length principle.

D.3.8.2. Transactions involving intangible assets are difficult to evaluate for the following reasons:

- Intangibles are rarely traded in the external market and it is very difficult to find comparables in the public domain;
- Intangibles are often transferred bundled along with tangible assets; and
- They may be difficult to detect.

D.3.8.3. A number of complications arise while dealing with intangibles. Some of the key issues revolve around determination of the arm's length rate of royalties, allocation of the cost of development of the market and brand in a new country, remuneration for development of marketing and R&D intangibles, their use, transfer pricing of co-branding, etc. Some of the Indian experiences in this regard are discussed below.

D.3.8.4. With regard to payment of royalties, MNEs often enter into agreements allowing use of brands, trademarks, know-how, design, technology, etc. by their subsidiaries or related parties in India. Such payments can be made as a lump sum or by way of periodic payments or a combination of both types of payment. Intellectual property, which is owned by one entity and used by another entity, generally requires a royalty payment as consideration for the use. However, the important issue in this regard has been the determination of the arm's length rate of royalty. The main challenge in determining the arm's length royalty rate is to find comparables in the public domain with sufficient information for comparability analysis. Further, it is difficult to find comparable arm's length prices in most cases. The use of the Profit Split Method as an alternative is generally not a feasible option due to the lack of requisite information.

D.3.8.5. Serious difficulties have been encountered in determining the rate of royalty charged for the use of brands and trademarks in certain cases. In some cases, the user had borne significant costs in promoting the brand/trademark, and to promote and develop customer loyalty for the brand/trademark in a new market. In these cases, the royalty rate charged by the MNE should depend upon the cost borne by the subsidiary or related party to promote the brand and trademark and to develop customer loyalty for that brand and product. In many cases, no royalty is charged from the local subsidiary in an uncontrolled environment and the subsidiary would require an arm's length compensation for economic ownership of the brand and trademark developed by it and for enhancing the value of the brand and trademark (legally owned by the parent companies) in an emerging market such as India.

D.3.8.6. In many cases, Indian subsidiaries using the technical know-how of their parent company have incurred significant expenditure to customise such know-how and to enhance its value by their R&D efforts. Costs of activities, such as R&D activities which have contributed to enhancing the value of the know-how owned by the parent company, are generally considered by the Indian transfer pricing administration while determining the arm's length price of royalties for the use of technical know-how.

D.3.8.7. . Significant transfer pricing issues have also arisen in cases of co-branding of a new foreign brand owned by the parent MNE (a brand which is unknown to a new market such as India) with a popular Indian brand name. Since the Indian subsidiary has developed valuable Indian brands in the domestic market over a period of time, incurring very large expenditure on advertisement, marketing and sales promotion, it should be entitled to an arm's length remuneration for contributing to increasing the value of the little known foreign

brand by co-branding it with a popular Indian brand and therefore increasing market recognition.

### **D.3.9. Intangibles generated through R&D activities**

D.3.9.1. Several global MNEs have established subsidiaries in India for research and development activities on a contract basis to take advantage of the large pool of skilled manpower which is available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark-ups. The parent MNEs of these R&D centres justify low cost plus mark-ups on the ground that they control all the risks and their subsidiaries or related parties are risk free or limited risk bearing entities. The claim of the parent MNEs that they control the risk and are entitled to a major part of the profits from R&D activities is typically based on the contention that they:

- Design and monitor all the research programmes of the subsidiary;
- Provide the funds needed for the R&D activities;
- Control the annual budget of the subsidiary for R&D activities;
- Control and take all the strategic decisions regarding the core functions of R&D activities of the subsidiary; and
- Bear the risk of unsuccessful R&D activities.

D.3.9.2. In transfer pricing audits of certain contract R&D centres, the following facts have emerged:

- Most parent companies of MNEs were not able to file relevant documents to justify their claim of controlling the risk of core functions of R&D activities and assets (including intangible assets), which are located in the country of their subsidiary;
- Contrary to the claims made by the parent companies, it was found that day-to-day strategic decisions and monitoring of R&D activities were carried out by personnel of the subsidiary who were engaged in actual R&D activities and bore relevant operational risks;
- The management of the Indian subsidiary also took decisions concerning the allocation of budget to different streams of R&D activities and Indian management also monitored the day-to-day performance of R&D activities; and
- While it was true that funds for R&D activities were provided by the MNE parents that bore the financial risk of the R&D activities, the other important aspects of R&D activities, such as technically skilled manpower, know-how for R&D activities, etc. were developed and owned by the Indian subsidiaries. Accordingly, control over risks of R&D activities lay both with the MNE parent



and the Indian subsidiary but the Indian subsidiary controlled more risks as compared to its MNE parent.

D.3.9.3. Thus, it has been inferred that the Indian subsidiaries were not risk-free entities but bore economically significant risks. Accordingly, Indian subsidiaries were entitled to an appropriate return for their functions, including strategic decision-making, monitoring R&D activities, use of their tangible and intangible assets and exercising control over the risks. In view of these facts, a routine and low cost plus compensation model would not arrive at an arm's length price.

#### **D.3.10. Marketing intangibles**

D.3.10.1. Transfer pricing aspects of marketing intangibles have been a focus area for the Indian transfer pricing administration. The issue is particularly relevant to India due to its unique market specific characteristics such as location advantages, market accessibility, large customer base, market premium, spending power of Indian customers, etc. The Indian market has witnessed substantial marketing activities by the subsidiaries/related parties of MNE groups in the recent past, which have resulted in creation of local marketing intangibles.

D.3.10.2. The functions carried out by Indian subsidiaries of an MNE Group relating to marketing, market research and market development, including adding value to intangibles such as brands, trademarks and trade names owned by parent companies, as well as creation and development of marketing intangibles like customer lists and dealer networks, have been the subject matter of transfer pricing adjustments in India. The expenditure incurred on these marketing functions has been considered for adjustment by Indian tax authorities on the premise that the Indian taxpayers were incurring these expenses for and on behalf of their parent companies outside India, and that:

- these expenses promoted the brands / trademarks that are legally owned by foreign parent AEs.
- these expenditures created or developed marketing intangibles in the form of brands / trademarks, customer lists, dealer/distribution channels, etc. even though the Indian company may have had no ownership rights in these intangibles.

Based on this premise, it has been held by the Indian tax authorities that the functions carried out, which are in the nature of development of the relevant intangibles, deserve compensation.

D.3.10.3. For computing the value of compensation and the required adjustment, a comparison with the average of AMP (Advertisement, Marketing and Promotion) spends by comparables in a broadly similar line of business has been made to determine the routine spend on AMP for product sale. The expenditure over and above this has been held to be purely for developing the brand value or other marketing intangibles for the benefit of the AE and as a service to the AE, and considered for adjustment along with a mark-up of the service charge on the same, worked out on a cost-plus basis. The understanding going into this approach has been that functions relating to development, enhancement and exploitation of marketing intangibles, now termed as DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) functions under the BEPS final report on Action Point 8, result in the following two-fold benefit to the AEs:-

(a) Direct Benefit: by way of increased revenue from the territory on account of Sale/Royalty/Fee for Technical Services etc. In many of the cases, such functions may have an impact on revenue enhancement of the associated enterprises in other parts of the world. For example sponsorship of events or sports watched in many countries, launching of brands developed in India in other parts of the world etc.

(b) Indirect Benefit:

(i) Development of Market: the AEs, who are owners of intangibles, obtain an advantage in terms of development of market for themselves. While this kind of advantage builds over a period of time, it is manifested in different ways, e.g. when the AE enters into an agreement with a third party for directly selling goods in India. It is observed in many cases that agreements are concluded in India by the foreign AEs with retail chain companies or e-sellers or large corporate houses, etc. Here, the awareness about the trade intangibles owned by the AE, which were not well-known in the Indian market, is enhanced by the marketing efforts made by the Indian taxpayer, thus adding value to the same. This practice of the Indian subsidiary also creates a platform for the AE when it launches new products in India. Although some of the Indian taxpayers are being compensated partly and some of them not, invariably no separate accounts are maintained by the taxpayer to show which part of the expenditure pertains to the DEMPE functions related to the intangibles and consequent benefits provided to the associated enterprise and which is incurred for routine promotion of the product. The pattern of compensation, if any, by the AEs for such functions is varied. While some of them provide a subsidy to the Indian subsidiary to maintain an agreed profit level, others grant a lump sum compensation which is generally not correlated by the taxpayer to functions discharged by it.

(ii) Enhancement of Exit Value: The marketing activity of the taxpayer bestows another kind of advantage to the AE which is realised when there is a change in ownership of the business – either by way of restructuring within the group or by way of divesting either a part or full business to a third party. At this stage, the exercise of market development, brand development or other value additions to the intangibles like copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret etc. are of tremendous importance while negotiating the price of divestment and valuation of assets.

D.3.10.4. The adjustments made by the transfer pricing officers (TPOs) have been subject to judicial reviews in India and although the matter is still to be finally adjudicated by the Supreme Court, the following principles have emerged from the decisions of the High Courts and Tribunals:

(i) The existence of an international transaction in relation to any service or benefit will have to be established before transfer pricing provisions can be applied to place a value on the service or benefit for the purpose of determining compensation.

(ii) The mere fact of unusual or excessive AMP expenditure cannot establish the existence of such a transaction. However, once such a transaction is established, it is possible to benchmark it separately and it need not always be aggregated with other international transactions.

D.3.10.5. The present approach of the Indian tax administration for carrying out transfer pricing adjustments in accordance with the above judicial principles is as below:

- Requesting the taxpayers to produce documents and evidence in a uniform manner including information of previous years
- Carrying out a detailed FAR analysis to identify all the functions of the taxpayer and the AEs pertaining to all international transactions e.g. purchase of raw material/components, payment of royalty, purchase of finished goods, export of finished goods, support services, and direct sales by the AE in India etc.
- Examining whether the marketing activities, marketing research, market development, distribution channel, dealers channel, customer list etc. (DEMPE functions) reflected by the expenditure incurred by the taxpayer and the AE in India are in conformity with the functional and risk profiles and the benefits derived by the taxpayer and the AE, and whether the AE, assuming a risk in the Indian market or

benefitting from India in one way or the other, is dependent upon the DEMPE functions carried out by the Indian subsidiary.

- Finding the most appropriate method to determine the arm's length compensation for the functions performed, assets used, and risks assumed by the Indian entity. The most appropriate method would depend on the facts of the case and could be the CUP method if suitable comparable uncontrolled transactions are found or could be the TNNM or PSM in appropriate cases.

D.3.10.6. The BEPS Report on transfer pricing issues illustrates through examples, the situations in which a marketeer/distributor can expect compensation for the AMP functions carried out by it. The common threads arising from these examples are:

- Compensation for the AMP function will depend on the intensity with which the function is performed, the extent of assets employed and the amount of risk borne by the parties in respect of the AMP function. Compensation need not be separate. It can be part of the price of another transaction. Where the AMP function is performed with the intention by the taxpayer to exploit the results itself, no separate compensation is receivable for the function.

The person who takes the important decisions relating to the AMP function such as deciding the strategy, fixing the budget and exercising overall control over the function is the person who bears the risk relating to the AMP activity and he is entitled to all the excess profits generated on account of the function.

D.3.10.7. The Indian tax administration has been applying these principles to make adjustments but it is apparent that the process is complex, fact intensive and not free from disputes. The efforts being made by the Indian tax authorities to bring uniformity in approach and the expected judicial verdict from the Indian Supreme Court are likely to bring more clarity in the process.

### **D.3.11. Intra-group Services**

D.3.11.1. Globalisation and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provide support to group entities in one or more locations by way of shared services. Some of the services are relatively straightforward in nature, such as marketing, advertisement, trading, management consulting, etc. However, other services may be more complex and can often be provided either on a stand-alone basis or as part of a package and are linked one way or other to the supply of goods or intangible assets.

D.3.11.2. The following questions are relevant to identify intra-group services requiring arm's length remuneration:

- Have the Indian subsidiaries received any related party services, i.e. intra-group services?
- What are the nature and details of services, including the quantum of services received by the related party?
- Have services been provided in order to meet the specific needs of the recipient of the services?
- Are they duplicate services (i.e., was the Indian subsidiary availing similar services on its own)?
- Did the Indian subsidiary have the capacity to absorb the services provided by the AE?
- What are the economic and commercial benefits derived by the recipient of intra-group services?
- In comparable circumstances, would an independent enterprise be willing to pay for and procure such services?
- Would an independent third party be willing and able to provide such services?

D.3.11.3. The answers to the above questions help in determining if the Indian subsidiary has received or provided intra-group services that require arm's length remuneration. Determination of the arm's length price of intra-group services normally involves the following steps:

- Identification of the cost incurred by the group entity in providing intra-group services to the related party;
- Understanding the basis for allocation of cost to various related parties, i.e., the nature of "allocation keys" used by the MNE;
- Considering whether intra-group services will require reimbursement of expenditure along with mark-up; and
- Identification of the arm's length price of a mark-up for rendering such services.

D.3.11.4. Identification of the services requiring arm's length remuneration is one of the main challenges for the transfer pricing administration. India believes that shareholder services, duplicate services and incidental benefits from group services do not give rise to intra-group services requiring arm's length remuneration. However, such a conclusion would need a great deal of analysis. The biggest challenge in determination of the arm's length price is the allocation of cost by using allocation keys. The nature of allocation keys generally varies with the nature of services.

D.3.11.5. Another challenge for the transfer pricing administration is the identification of pass-through costs, on which mark-ups should either not be paid (if the Indian entity is the recipient of such services) or not received (if the Indian entity is the service provider).

Wherever a mark-up is to be paid or received, the determination of an arm's length mark-up is also a challenge.

D.3.11.6. In view of the above facts, transfer pricing of intra-group services is considered a high risk area in India. India considers the payment for such intra-group services to be base-eroding in nature and, accordingly, attaches great importance to the transfer pricing of such payments. Further, even if an arm's length result is achieved in respect of such payments from India, an additional protection in the form of an overall ceiling on the amount of such payments may be required. This may be justified because even an arm's length payment might result in erosion of all the profits of the Indian entity or in enhancement of losses of the Indian entity, thereby, making the arm's length nature of such payments questionable. Thus, an overall ceiling on such payments in the form of a certain percentage of the sales or revenue of the Indian entity is being used in appropriate cases.

#### **D.3.12. Financial Transactions**

D.3.12.1. In India, the transfer pricing approach for inter-company loans and guarantees revolves around:

- Examination of the loan agreement;
- A comparison of terms and conditions of loan agreements;
- The determination of credit ratings of lender and borrower;
- The identification of comparable third party loan agreements; and
- Suitable adjustments to the comparables to enhance comparability.

D.3.12.2. The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent has advanced to its AEs in a foreign jurisdiction interest free loans or loans either at LIBOR (London Interbank Offered Rate) or EURIBOR (Euro Interbank Offered Rate). The main issue before the transfer pricing administration is the benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans.

D.3.12.3. A further issue in financial transactions is credit guarantee fees. With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to their associated entities abroad, where the Indian parent as guarantor agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an associated entity of the Indian parent to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantee under the Comparable Uncontrolled Price Method. In most cases, interest rate quotes and guarantee rate quotes available from banking companies are taken as

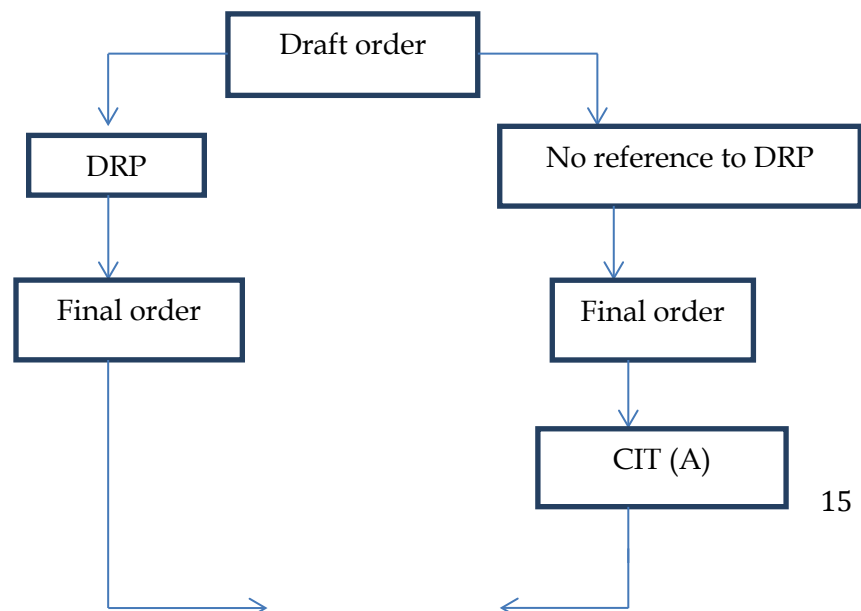
the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in the credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of Indian bonds is also considered for determination of the arm's length price of such guarantees.

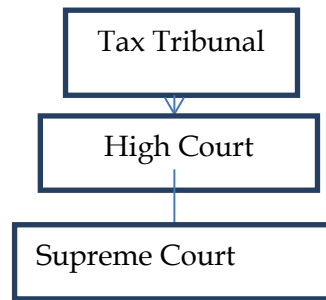
D.3.12.4. However, the Indian transfer pricing administration is facing a challenge due to the non-availability of specialised databases and of comparable transfer prices for cases of complex inter-company loans and mergers and acquisitions that involve complex inter-company loan instruments as well as an implicit element of guarantee from the parent company in securing debt.

**D.3.13. Dispute Resolution**

D.3.13.1. A comprehensive dispute resolution mechanism is available to the taxpayers in India facing transfer pricing adjustments. As a part of the legal process in all cases, the Assessing Officer (AO) incorporates the order of the Transfer Pricing Officer (TPO) in his order and issues a draft order to the taxpayer. The taxpayer has the option to file an objection against the draft order before the Dispute Resolution Panel (DRP) which is a panel comprising three Commissioners of Income-tax. The AO issues a final order in compliance with the DRP's directions. At present, the direction of the DRP is final for the tax administration and it cannot appeal further against the DRP's order. The taxpayer can challenge the direction of the DRP in appellate forums.

D.3.13.2. The sequence and availability of dispute resolution forums to the taxpayer in India is depicted below.





D.3.13.3. The Indian tax administration is aware of the problem of increasing transfer pricing disputes and the impact on the investment climate in India. Therefore, the Government of India has taken several steps to reduce litigation and the time needed to resolve tax disputes. Some of the steps taken in this direction are the following:

- Risk-based selection of cases for transfer pricing audit instead of selecting all cases above a particular monetary limit of the value of international transactions for audit;
- Introduction of the ‘Range’ concept in the Transfer Pricing Law along with the use of multiple-year data ;
- Use of the Mutual Agreement Procedure (MAP) for speedier resolution of pending cases;
- Introduction of Advance Pricing Agreement (APA) provisions in the law; and
- Introduction of Safe Harbour provisions in the transfer pricing law.

#### **D.3.14. Advance Pricing Agreement (APA)**

D.3.14.1. India introduced the Advance Pricing Agreement (APA) provisions in its legislation in 2012. An APA is an agreement between the Central Board of Direct Taxes (CBDT) and any person, to determine, in advance, the arm’s length price or specify the manner of determination of the arm’s length price (or both), in relation to an international transaction. Once an APA has been entered into, the arm’s length price of the international transaction will be determined in accordance with the terms of the APA for the period specified therein. An APA can be entered into for a maximum period of 5 years and can be renewed thereafter. The APA process is voluntary but once an APA is entered into, it becomes binding for both the taxpayer and the CBDT.

D.3.14.2. APAs can be unilateral, bilateral or multilateral. An applicant may request a particular type of APA while making the application. The scheme provides for an optional



pre-filing consultation between the taxpayer and the APA team before filing a formal application. Such consultation can be on anonymous basis. The application is to be filed along with the specified fee. The Indian APA Scheme also provides for a rollback of the APA for a period of 4 years prior to the first year of the APA period. Therefore, the combined impact of an APA with rollback provisions is tax certainty for 9 years. Rollback is not available for a year in which the Income Tax Appellate Tribunal (ITAT) has pronounced its decision on the issues proposed to be covered under the APA/Rollback. All the procedures relating to the APA Scheme have been prescribed in detail under the APA Scheme in the Income-tax Rules and certain issues have also been clarified by the CBDT through various Circulars and Frequently Asked Questions (FAQs).

D.3.14.3. The Indian APA program has been well received by the taxpayers and more than 700 applications have been filed in the first 4 years. Almost 100 APAs have already been entered into by the CBDT. The APAs entered into so far cover various sectors of the Indian economy including information technology, automobiles, telecommunications, steel, shipping, general trading, banking, pharmaceuticals, etc. It is expected that the robust APA program in India would go a long way in reducing transfer pricing disputes and providing certainty to MNEs in such matters.

### **D.3.15. Safe Harbour**

D.3.15.1. India has introduced safe harbour provision in its legislation in 2009. Rules for administering the provision were subsequently notified. Safe harbour provisions are intended to reduce the compliance burden for small taxpayers with regard to transfer pricing issues. Sectors/transactions covered under safe harbour rules are the following:

- Software Development;
- IT Enabled Services;
- Knowledge Process Outsourcing Services;
- Outbound Intra-Group loans;
- Corporate Guarantees;
- Contract R&D Services in Software;
- Contract R&D Services in Pharmaceuticals;
- Manufacture and export of core auto components; and
- Manufacture and export of non-core auto components.

### **D.3.16 The Base Erosion and Profit Shifting (BEPS) Final Reports on Actions 8, 9, 10 and 13**

D.3.16.1. India has endorsed the final report of the BEPS project on Actions 8, 9 and 10 dealing with various transfer pricing issues. Some of the issues addressed in the BEPS reports, such as the broad objective of aligning transfer pricing outcomes with value creation; giving importance to the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions in respect of intangibles for remunerating the group entities of MNEs; testing of contractual allocation or contractual assumption of risk on the parameters of exercising control over risk and/or the financial capacity to bear the risk, and disregarding such contractual allocation or assumption of risk; harmonising contracts with the conduct of parties; identifying and accurately delineating the transaction (i.e., identifying the “real deal”) by analysing the economically relevant characteristics; preventing the capital-rich but low-functioning entities (the “cash box” entities) from contributing to base-erosion or profit-stripping; non-recognition of commercially irrational transactions that cannot be seen between independent parties; etc. are in conformity with the long standing views of the Indian transfer pricing administration. Accordingly, the Indian tax administration is of the view that the guidance flowing from the final report of the BEPS project on Actions 8, 9 and 10 should be utilised by both the TPOs and the taxpayers in situations of ambiguity in interpretation of the law. However, India has not endorsed the guidance in the BEPS report pertaining to Low Value Adding Intra Group Services (LVAIGS) under Action 10 and has not opted for the simplified approach.

D.3.16.2. India has also endorsed the recommendations contained in the BEPS final report on Action 13, which attempts to completely change the transfer pricing documentation standards. India has supported the three-tiered documentation regime comprising a Local File, a Master File and a Country-by-Country (CbC) Report and has already carried out legislative changes in its domestic law.