Bloomberg BNA

Tax Management
Transfer Pricing Report™

VOL. 22, NO. 3 JUNE 13, 2013

As Aggressive Audits Continue in India, Hopes Turn to High Courts, APA Program

By Kevin A. Bell

Transfer pricing uncertainty has long been a fact of life for multinational companies operating in India. For years, businesses have had to contend with aggressive transfer pricing audits, which have led to prolonged court disputes or difficult competent authority negotiations—or both.

Preliminary estimates from the country's Income Tax Department show a worsening of this trend. Tax officers reportedly made adjustments of 700 billion rupees ($12.7 billion) under the country's transfer pricing rules for the latest financial year—a 57 percent increase in the total adjustment amount from the prior year (22 *Transfer Pricing Report* 120, 5/30/13).

Practitioners interviewed by BNA gave a variety of reasons for the large audit adjustments: revenue targets for transfer pricing officers; the tax authority's insistence on using the arithmetic mean rather than the interquartile range to determine arm's-length results, as well as its preference for the profit split method; regulations mandating the use of single-year data; and use of the bright-line test to disallow costs for Indian subsidiaries.

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Miller Williams, Ernst & Young

The adjustments resulting from these approaches routinely cause double taxation—a particular problem for U.S. multinationals. Internal Revenue Service Deputy Commissioner (International) Michael Danilack, the U.S. Competent Authority, has cited a backlog of 140 U.S.-India mutual agreement procedure cases as one reason the United States will not engage in advance pricing agreements with India (21 *Transfer Pricing Report* 962, 2/7/13).

According to one practitioner—Miller Williams of Ernst & Young LLP in Atlanta—the IRS currently is telling taxpayers to take their transfer pricing disputes to court in India "because you will end up with a better position."

But courts offer little hope that an adjustment will be overturned in the short term. Years pass between the conclusion of an audit and a decision by the relevant tax tribunal, with no guarantee of a desired result. Moreover, because the tax authority routinely contests taxpayer-favorable decisions in the high courts, those decisions are not binding on the authority, and no precedent is established.

Practitioners expressed cautious optimism that the situation would abate in the next three to five years as high courts begin to render decisions in these appealed cases and some precedent is established. In the shorter term, some saw potential alternatives to litigation in India's new advance pricing agreement program and possible safe harbor provisions.

Targets for Revenue—and Results

Ashutosh Mohan Rastogi of the Delhi-based law firm Amicus Advocates & Solicitors blamed revenue targets for the aggressive audits. These targets, he said, filter down from the Finance Ministry to ground-level officers whose performance is judged by the amount of adjustments made. He also said transfer pricing officers tend to rely on the results from previous years, which "eliminates the practical possibility of a favorable assessment if an adjustment was made in the previous year."

Speaking to another type of target, Rahul Mitra of PricewaterhouseCoopers in Gurgaon said that if Indian authorities were to accept results falling in the interquartile range as arm's-length, "then half of these disputes around comparability would go away."

Instead of using the interquartile range—the middle 50 percent of results from a comparability analysis—to determine an arm's-length result, the Indian Revenue

 ISSN 1063-2069

Department calculates the arithmetic mean of the comparables and applies a tolerance band of a specified percentage. Mitra noted that the authorities recently narrowed the accepted band from plus or minus 5 percent to plus or minus 3 percent, ''imposing an even more onerous exactitude'' on taxpayers (22 *Transfer Pricing Report* 19, 5/2/13).

Profit Split Method

Williams pointed to two circulars issued by the CBDT in March, one of which notes the tax authority's preference for the profit split method—an approach he said can lead to absurdly high adjustments.

The circular on profit split identifies the method as the most appropriate for pricing related-party transactions involving intangibles, and the other circular sets out the requirements that must be satisfied for a research and development center to be classified as a contract R&D unit with ''insignificant risks'' (21 *Transfer Pricing Report* 1139, 4/4/13).

Williams said that if the R&D center meets the limited criteria under the circular, it could qualify as a contract R&D business; however, the circular does not reach a conclusion on the transfer pricing implication of being classified as a contract R&D business.

The circular on profit split essentially states that the method is preferred for R&D centers without making an exception for contract R&D businesses.

''That is where you can end up with the charge being some kind of fee, or royalty, based on global revenue, or any kind of revenue that the Indian entity is associated with, and that is where you can end up with absurd results like cost plus 300 percent,'' Williams said.

Service Companies

Meanwhile, Rastogi said the tax authorities apply markups in the range of 25-30 percent across the board to information technology companies and information technology enabled service providers, irrespective of their functional profile, including ''cost plus captive units facing low risk.''

Similarly, he said that in the last three rounds of transfer pricing assessments, ''a virtual disallowance spree of management charges has been witnessed.'' In addition, the bright-line test ''has been applied in a brazen manner to distributors and manufacturers regardless of their entrepreneurial nature,'' and recently ''guarantees fees have also come under the scanner and being adjusted without any analysis of benefit received or 'shareholder' function performed by the parent company.''

The bright-line test compares the marketing spend of the Indian tested party and the comparables and has resulted in significant transfer pricing adjustments from disallowed marketing costs to Indian subsidiaries. Practitioners have said the approach disregards the functional and risk allocation between Indian companies and their foreign affiliates (21 *Transfer Pricing Report* 1047, 2/21/13).

Single-Year Data

Rastogi said regulations mandating the use of single, current-year financial data to determine arm's-length prices are another contributor to adjustments, as this data, which would be available to the tax authority at the time of audit, usually is not available to the taxpayer at the time of its transfer pricing planning or documentation.

Mitra said that largely due to the tax authority's use of this data as well as the arithmetic mean, ''the tussle with respect to exorbitant margin comparables will continue'' and as a result, ''the overall markup will go up to a very high number and taxpayers will have no other choice but to litigate.''

Litigation

Mitra said the income tax appellate tribunals have decided almost 550 transfer pricing cases in the last six years.

In addition to large adjustments, he said, a factor driving litigation is that going to court is less expensive in India than in other jurisdictions. ''People litigate at the drop of a hat, even for adjustments less than $50,000, which is relatively low in terms of cross-border transactions,'' he said.

Rastogi noted the Indian Revenue Department's unwillingness to follow the transfer pricing rulings of the tribunals once a case is decided. Principles laid down by these courts in one case, he said, will be ignored in other cases—even when the other case involves different years of the same taxpayer.

The last three rounds of audits have seen ''a virtual disallowance spree of management charges.''

ASHUTOSH MOHAN RASTOGI, AMICUS ADVOCATES & SOLICITORS

The reason given for this practice invariably is that the Department is contesting the tribunal decision before the higher court, and thus the tribunal ruling is not binding on the Department, Rastogi said. ''This is a very important reason why huge litigations come up to the tribunal year after year.''

This practice prevents rulings such as the one by the Delhi Income Tax Tribunal in September 2012, which could have served as valuable guidance in the services area, from being relied on. Experts hailed the case as well-reasoned and said it provides a guidepost for determining whether other Indian related-party procure-

ment companies are providing routine, low-risk services, or are instead engaged in the provision of high-value procurement functions (21 *Transfer Pricing Report* 1005, 2/7/13).

However, if past experience is any guide, the tax authority is almost certain to appeal the decision to the Delhi High Court.

Sanjiv Malhotra of BMR Advisors in Gurgaon said that so far there have been few high court decisions and ''no clear trend can be established.'' But as these courts start to render decisions on appeals from the tribunals in the next several years, he said, some level of certainty may result. High court decisions are binding on the ITAT and authorities of the same state, and should be followed by the other states as a matter of judicial discipline.

Porus Kaka, a Mumbai practitioner recently appointed president of the International Fiscal Association, noted that transfer pricing is fact-driven by nature. Still, he said, high court decisions may bring clarity on some legal principles, such as the applicability and hierarchy of methods as well as some procedural issues.

Advance Pricing Agreements

In the meantime, approximately 145 taxpayers are seeking certainty through India's new APA program. Despite Danilack's comment that U.S. taxpayers are unlikely to receive better treatment there than in the MAP process, recent guidance offers hope that APA officials will take a more flexible approach, especially in bilateral cases (22 *Transfer Pricing Report* 118, 5/30/13).

Among the answers to 40 ''frequently asked questions'' on APAs from India's Central Board of Direct Taxes were the following responses:

- APAs need not cover all of a company's international transactions; additional transactions may need to be covered in the APA if they are ''intrinsically linked with another international transaction in a manner that one cannot be benchmarked independently.''
- History of a case will be considered, but past positions need not ''guide or decide the APA process.''
- Unilateral cases may be converted into bilateral cases, and vice versa.
- APAs may be obtained for cases involving a permanent establishment.
- ''Other methods'' or ''sixth methods'' would be allowed.
- Indian officials have been able to resolve MAP cases with countries whose law mandates use of the interquartile range rather than the arithmetic mean and will follow the same approach in APAs.
- Renewal cases are likely to take less time than the original APA if the facts are the same.

Progress

Mitra said the Indian APA Program has 14 staff dedicated to processing the unilateral and bilateral APA applications, and that work on cases has already begun. The staff want to finish the fact finding and functionality interviews by June or July so they can make their recommendations to the CBDT for early resolution of the APAs.

Williams said the Indian APA authority is starting to process the APA applications and that some of E&Y's clients have already had initial meetings with the Indian authorities, who are ''looking in the next month or two to have a site visit to interview company employees.''

Mitra said this amount of progress ''is unbelievable and we need to doff our hat to the APA authorities.''

Malhotra, asked to comment on the timing of the agreements, said it is difficult to predict when the first one will be concluded. ''Anything that gets completed this calendar year would be fantastic but we hope we will see a few unilateral APAs closing by March 2014,'' Malhotra said.

Safe Harbors

Along with APAs, transfer pricing safe harbors rules could provide an alternative to litigation, Mitra said. For example, he noted, senior officials in the Indian Revenue have suggested a safe harbor of around 20 percent for companies in the services industry.

The CBDT has not issued safe harbor rules, although it has had the ability to do so since the passage of India's 2009 budget (18 *Transfer Pricing Report* 275, 8/6/09).

A committee was formed on safe harbors in July 2012 to review the taxation of development centers—captive entities through which many multinational corporations carry out product and software R&D and other analytical work in the IT, pharmaceutical, science, and other industries—and the IT sector (21 *Transfer Pricing Report* 364, 8/9/12).

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