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Transfer Pricing Report™

Transfer Pricing Adjustments in India: Taxpayer Mispricing or Tax Authority Aggression?

The author reports the total transfer pricing adjustments made in India since the country began audits under its new regime in 2002 and examines the factors responsible for the significant allocation amount, which has increased each year.

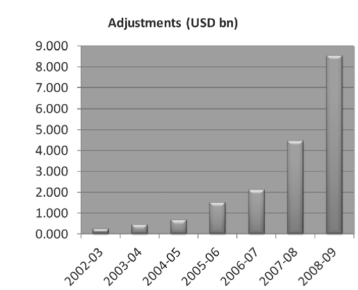
BY ASHUTOSH MOHAN RASTOGI

The seventh round of transfer pricing audits in India will remain memorable for its shock value as much as for the contentious issues that surfaced in the 2008-09 examination year, for which the tax authority proposed a record 445 billion rupees ($8.5 billion) in transfer pricing adjustments. The significance of this development can be better understood when one considers the fact that this amount is equivalent to the total value of adjustments made in all prior audit rounds put together.

India issued final transfer pricing rules in August 2001, following a draft in May of the same year,[1] and began transfer pricing audits under the rules in the 2002-03 assessment year. The charts below show the movement of adjustment value year by year.

Trend Line – Transfer Pricing Adjustments in India

Assessment Year	TP Adjustment (USD bn)
2002-03	0.23
2003-04	0.44
2004-05	0.66
2005-06	1.49
2006-07	2.09
2007-08	4.46
2008-09	**8.55**



Source - Presentation by DIT (Transfer Pricing) – II, Delhi, at FIT Conference held in Mumbai from 1st – 3rd Dec, 2011

A glance shows the curve moving upwards with great momentum. Nearly each year has shown a 100 percent growth in the quantum of adjustment from the previous year. For example, the $8.5 billion in adjustments made for the latest year are close to double the $4.46 billion made the previous year.

What are the causal factors behind such huge transfer pricing adjustments? Is mispricing in India truly endemic, or are systemic gaps responsible for these results? This article examines some the factors responsible for the significantly high—and increasing—transfer pricing adjustments in India year after year.

Generic Factors

More than half of the total tax demand in 2008-09 was from the assessment of just 11 multinationals, including foreign banks and telecommunications companies, who allegedly mispriced their cross-border transactions. The 11 multinational companies presumably include Vodafone, which is facing a tax demand of 85 billion rupees ($1.7 billion) from transfer pricing for its 2007-08 year, which corresponds to the 2008-09 assessment year.[1]

Factors contributing to the record-breaking allocations for the year include:

- a target-driven mindset on the part of auditors;
- a tendency by auditors to use the same approach from year to year regardless of whether a company's facts have changed;

[1] See 10 *Transfer Pricing Report* 83, 5/30/01; 10 *Transfer Pricing Report* 358, 9/19/01. For discussion of the final rules, see 10 *Transfer Pricing Report* 436, 10/17/01.

[1] The transfer pricing dispute is a separate matter from the $2.2 billion Supreme Court case involving taxation of offshore transfer of shares—a case decided in the company's favor Jan. 20. See the related article in this issue.

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- use of data from only one year;
- use of the arithmetic mean rather than a range of comparables;
- across-the-board markups in certain industries; and
- an absence of safe harbor or APA provisions.

Target-driven mindset

Year after year, revenue targets percolate down from the Indian Finance Ministry to ground-level officers whose performance is judged by the quantum of adjustments undertaken. Not surprisingly, the Indian revenue authority has earned a reputation as one of the world's most aggressive tax authorities.

Reliance on previous year's approach

Even though it is well accepted that each tax year is different and should be judged on its own facts, tax examiners' reliance on the approach used in previous years eliminates the practical possibility of a favorable assessment if an adjustment was made in the previous year. Target-driven orientation compels officers to perpetuate the legacy of adjustment, and the cycle goes on and on.

Multiple- versus single-year data

A significant part of adjustment results from a peculiar feature of Indian transfer pricing regulations mandating use of single- or current-year financial data for arm's-length price determination. Such data usually is not available to the taxpayer at the time of transfer pricing planning or documentation. Hence, the use of such updated data (not available to taxpayer earlier) often puts the taxpayer outside the permissible limits, resulting in an adjustment.

Use of arithmetic mean

Indian transfer pricing regulations apply the concept of arithmetic mean for determining the arm's-length price. The statistical proxy substitutes the entire range of comparable prices with a single figure (a narrow plus or minus 5 percent around the transfer price is permitted), imposing unrealistic exactitude and compliance burdens on the taxpayer. This is at odds with the international best practice of relying on a full range or the interquartile range when determining the arm's-length nature of international transactions.

Departmental stand and mechanical application of key concepts

Over time, the Indian revenue authorities have embraced specific positions on core issues that often are applied in a routine manner. For example, the tax department's stand on information technology sector ensures that markups between 25 percent and 30 percent are applied across the board to IT and IT-enabled services companies irrespective of their functional profile (cost plus captive units facing low risk).

Similarly, in the last three rounds, a virtual disallowance spree of management charges has been witnessed, notwithstanding comprehensive documentation supporting a benefit test. A bright-line test also has been applied to distributors and manufacturers regardless of their entrepreneurial nature. Of late, guarantee fees have come under scrutiny as well and are being adjusted without any analysis of the benefit received or the shareholder function performed by the parent company. Below is a tabular summary of the gradual evolution of transfer pricing audits from the year those audits commenced to date.

Evolution of Transfer Pricing Issues in India

Assessment Year	Core Issues in Audit
2002-03	Single- versus multiple-year / choice of comparables
2003-04	Single- versus multiple-year / choice of comparables
2004-05	Single-year versus multiple-year / choice of comparables/ adjustments in information technology sector
2005-06	Single year vs multiple year / choice of comparables/ adjustments in information technology sector
2006-07	Single- versus multiple-year / choice of comparables / adjustments in information technology sector, marketing intangibles (more so after *GlaxoSmithkline*), disallowance of management charges
2007-08	Single- versus multiple-year / choice of comparables / adjustments in information technology sector, marketing intangibles, disallowance of management charges, guarantee fees (these caught the tax authority's attention particularly after the *GE Capital Canada* case on guarantee payments)[2]
2008-09	Single- versus multiple-year / choice of comparables/ adjustments in information technology sector, marketing Intangibles, disallowance of management charges, guarantee fees

Thus, in terms of nature, the disputes have evolved from being predominantly driven by data and comparability to involving complex issues such as marketing intangibles and guarantee arrangements. While the enforcement of India's transfer pricing regulations has kept pace with developments in the international arena, the sweeping manner in which some of the concepts have been applied leaves much to be desired.

Absence of safe harbor regulations, APAs

Finance Act 2008 empowered the Central Board of Direct Taxes (CBDT)—the Indian apex administrative authority on tax matters—to formulate safe harbor rules. However, these rules have not been introduced to date. Currently, the advance pricing arrangement mechanism also is absent, though it is likely to be introduced in next fiscal year under the Direct Tax Code. The introduction of these measures is expected to stem the tide of transfer pricing adjustments significantly.

Sectoral Issues—Trends

The Indian revenue authorities follow several practices in the pharmaceutical, IT, automotive, and other industries that are designed to produce adjustments.

[2] *General Electric Capital Canada Inc. v. The Queen*, 2010 FCA 344.

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Pharmaceuticals

The price at which active pharmaceutical ingredients (APIs) are imported has been a moot issue for pharmaceutical companies. Notwithstanding the quality differential, the revenue authorities have compared the price of imported APIs with prices of locally manufactured APIs and disallowed ''excessive'' amounts paid to the overseas group company.[3] While in some cases, adjustments for quality differential have been allowed, these adjustments have been ad hoc and far from satisfactory.

In most cases, the transactional net margin method (TNMM) deployed by the taxpayer has been substituted by comparable uncontrolled price (CUP) method. The substitution often occurs without regard to the business model or functional profile of the Indian subsidiary or the uniqueness of APIs, rendering CUP unfit for testing the arm's-length nature of the import transaction.

Information technology

Transfer pricing for the IT sector has been controversial ever since the introduction of comprehensive transfer pricing legislation in India. The revenue authorities have compared ''captives'' with full-fledged entrepreneurs without allowing a risk adjustment. Contrary to established jurisprudence, in several cases, companies with abnormally high margins have been considered as comparables, while loss-making units (though not necessarily unviable) have been excluded. With the arithmetic mean as the statistical proxy, this selection of extremes has led to skewed results.

Another issue is the inclusion of companies owning software products. Taxpayers have been arguing for the exclusion of such companies since captives merely develop ''modules'' without assuming ownership of the end product. Inclusion of such companies artificially inflates the arm's-length return for captives.

The cumulative result of the benchmarking approaches described above has been a cost plus margin in the range of between 25 percent and 30 percent, fueling adjustments year after year.

Fast-moving consumer goods

Disallowance of ''excessive'' brand promotion expenditure has been the core issue fueling transfer pricing adjustments in the fast-moving consumer goods sector. In the first instance, comparable product or service providers are identified and their average marketing spend (the ''bright line'') is determined. Thereafter, the taxpayer's marketing expenditure over and above the bright line is disallowed on the ground that it fails the industry standard. The revenue authority's argument for disallowance is that the disallowed expenditure benefits only the parent (whose brand is promoted) and not the subsidiary. While these adjustments surfaced largely during the fifth round of transfer pricing audits, they peaked in the sixth round following the Delhi High Court's decision in the case of *Maruti Suzuki*.[4]

Royalty payments, disallowance of management charges, and guarantee fees are some other key issues giving rise to transfer pricing adjustments in this sector.

Automobiles

As discussed above, after the *Maruti Suzuki* decision, marketing intangibles have come under increasing scrutiny even for the automobile sector. Choice of imported components versus localization is another critical issue faced by the industry. In some of the cases, prices for imported components have been compared with prices of localized inputs developed several years subsequent to the relevant financial year.

Conclusion

A variety of factors have contributed to the significantly high adjustments in India. While one cannot rule out genuine cases of mispricing, one also cannot deny that Indian revenue authorities have been quite aggressive in enforcing the transfer pricing regulations.

Hopefully, taxpayers will see a moderation of this trend once important and expected legislative measures such as safe harbor rules and APAs are introduced.

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[3] See *Serdia Pharmaceuticals (India) Private Limited v. ACIT (Mumbai Bench)*, ITA Nos. 2469/Mum/06, 3032/Mum/07 and 2531/Mum/08, covered in 19 *Transfer Pricing Report* 905, 1/13/11.

[4] The recent Delhi High Court judgment in the case of *Maruti Suzuki India Limited v. Addl. Comr. of Income Tax*, TPO, New Delhi, W.P. (C) 6876/2008, created quite a flutter by endorsing the revenue authority's stand on marketing intangibles at least in part (see 19 *Transfer Pricing Report* 303, 7/15/10). However, a subsequent Supreme Court decision rendered the High Court order ineffective (see 19 *Transfer Pricing Report* 697, 10/21/10). Even so, the High Court judgment continues to inspire the tax department to adjust taxpayers' transfer pricing aggressively.