

**Bloomberg
BNA**

TRANSFER PRICING **INTERNATIONAL JOURNAL**

International Information for International Business



VOLUME 15, NUMBER 7 >>> July 2014

www.bnai.com

Indian Budget's amendments to Transfer Pricing provisions – a further step towards a predictable tax environment

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India's transfer pricing regime has been the subject of significant criticism. July's Union Budget included a number of revisions to the regime, which, it is hoped, will simplify the system for taxpayers.

I. Introduction

Since its introduction in the Finance Bill 2001, the Indian transfer pricing provisions/regulations (India TP regulations) have been a matter of huge debate and consequentially a tremendous amount of litigation. Lack of conceptual clarity and a high level of subjectivity in the application of rules and various methods has rubbed salt into the wounds of assesseees. Thus, India has been the subject of a great deal of focus in the last decade, as far as transfer pricing litigation is concerned. The number of cases in which adjustments have been made has increased by approximately five and half times from 2001 to 2013 and the amount of additions has increased from approximately US\$ 275 million to approximately US\$ 8.9 billion during the same period,

and counting. Many large MNCs, such as Shell, Vodafone and Nokia are already facing the heat of transfer pricing litigation.

Considering the drastic increase in the number of tax disputes involving transfer pricing, the UPA government had laid the stepping stone towards resolving these disputes by introducing the Advance Pricing Agreement ("APA") regime and the Safe Harbour rules.

The newly elected NDA government has made clear its intention to have a favourable and predictable tax regime for foreign investors and, as part of their long term agenda, have proposed some important amendments to transfer pricing provisions as part of their proposals for the Union Budget 2014-15.

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II. Proposed amendments

Amendments are proposed to the following transfer pricing provisions:

- i) roll back of Advanced Pricing Agreements;
- ii) use of multiple year data for comparability analysis;
- iii) computation of arm's length price; and
- iv) amendment to the definition of International Transactions.

III. Analysis of the proposed amendments

A. Roll back of APAs

Advanced Pricing Agreements are a tool for taxpayers to provide certainty on the arm's length price for future international transactions. The APA is thus an agreement between the taxpayer and the income tax authorities for the determination of arm's length price and an appropriate TP methodology for arriving at the same for a set of international transactions over a fixed period of time in future.

Currently, the Indian APA programme provides certainty to taxpayers by specifying in advance the arm's-length pricing for cross-border transactions among related parties for prospective years. In order to provide a stable and non-adversarial tax regime, the Indian Finance Ministry has amongst other proposals, proposed to provide for Rollback of APA and apply it for the past open years.

The move seems to be an attractive proposition to further certainty to taxpayers and foreign investors and afford much needed relief to the international tax-paying community, weary of challenges presented by aggressive regulatory positions and chronic litigation and desperate for sustainable resolution strategies in a highly litigious system.

1. Manner of application

The draft proposals inserted by subsection (9A) to Section 92CC reveal that the roll back provisions would apply to APAs signed after October 1, 2014, where the APA has to specifically state its applicability for roll back for those past years.

Thus, an APA signed prior to October 1, 2014 cannot be available for roll back, since there would be no mechanism to inset the scope of roll back in such APAs.

2. Potential evolution of the views of income tax authorities

While the new Government is paving the way for resolving TP litigation through the roll back mechanism, the litmus test of the machinery will really be the willingness on the part of the APA Authorities and accordingly the CBDT, to actually modulate their views in APAs (compared to those taken in TP assessments up to now), where propriety and accountability might suggest that digression from those earlier views would only be rational; and also do justice to the introduction of world class reforms, which have the potential to place India at par or even higher than other matured tax administrations in the world.

B. Use of multiple year data for comparability analysis— A very welcome move

At present the Indian TP regulations recommend usage of the current year's data for comparability analysis, unless a taxpayer demonstrates that prior years' data (specifically, the last two years) has influenced the fixing of transfer prices. Concurrently, the Indian TP regulations also mandate maintenance of annual documentation and filing of an accountant's certificate by the due date of filing of the tax return (i.e. by September 30 for the assessment year 2010-11; and from November 30 onwards for the assessment year 2011-12, as amended by the Finance Act 2011).

However, as on the due date of filing of tax return, a negligible proportion of the entirety of companies available in public databases (i.e. Prowess and Capitaline) report the current year's data. Therefore, on the due date of tax compliance, it is impossible for taxpayers to derive a proper representative set of companies reporting the current year's data for a meaningful comparability analysis. Thus, in reality, taxpayers are compelled to resort to multiple years' data when preparing the TP documentation at the time of filing of tax return.

However, at the time of TP assessments, which typically take place three years after the end of the relevant financial year, Transfer Pricing Officers (TPOs) will have had access to comparable data relating to the current year by referring to updated versions of the public databases (i.e. Prowess and Capitaline), and will have selected data, which are reported in the relevant databases long after the due date of filing of the income tax return, and which taxpayers would not have had access to.

As a result the documentation filed by the taxpayer at the time of the filing return deadline is rendered redundant as the taxpayer could not access the required data, in order to comply with the mandatory requirements.

Apart from the confusion of the above scenario, the utility of using data from multiple years serves as a better reflection of the overall study and provides useful insights in understanding long term arrangements, businesses and product cycles.

The practice of using data from multiple years is also followed by countries such as Australia, China, Denmark, France, Finland, Germany, Italy, Netherlands and Spain, where the transfer pricing provisions were reformed a number of years ago.

C. Computation of arm's length price ("ALP") – Use of range concept

Indian Transfer Pricing regulations prescribe the use of the Arithmetic Mean ("AM"), with a range of (+)/-3 % for the determination of ALP.

The major disadvantage with using AM is that it vitiates the overall comparability analysis, as extreme results distort the comparables set. Compared to AM, the "inter-quartile range" method provides a more accurate result of ALP, as extreme results are filtered out from the study.

The practice of using "inter quartile range" is followed in many countries such as Australia, China,

Denmark, France, Finland, Germany, Italy, Netherlands and Spain and the method is also recommended by the OECD.

D. Amendment to the definition of International Transactions – widening of applicability

The deeming Transfer Pricing provisions, which currently apply to transactions between two enterprises, where one of them is non-resident in India, are now proposed to be extended to transactions between an enterprise and an independent person where there is a prior arrangement between the independent person and associated enterprise, irrespective of whether such independent person is a non-resident or resident.

Thus the scope of application of transfer pricing provisions is proposed to be widened to cover even transactions between two residents.

IV. Conclusion

The proposals made by the Finance Minister are welcome and if enacted, would go a long way, in bringing greater clarity and accordingly in resolving the disputes in the transfer pricing arena. It is also worthwhile to note that the proposed changes are in line with globally followed practices which, it is hoped, could have a big impact in restoring the faith of foreign investors in investing in India.

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