EMERGING TRENDS IN INDIAN TRANSFER PRICING

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Introduction

Transfer pricing ("TP") continues to be the most important global tax issue before tax authorities and multinational enterprises (MNEs) owing to the widespread globalisation and challenges posed by the new age economies. TP within the tax world refers to the pricing of intra group transactions by companies within their groups spread outside their home country. If TP is manipulated, the tax owed within each country basis the actual operations carried out would not be commensurate.

In India, TP has rapidly matured since its introduction from the financial year (FY) 2001-02 and more or less on par with countries with mature TP legislations like UK, Canada, Australia, Japan. However, TP litigation in India peaked in a shorter time frame placing India as one of the third highest TP litigating countries in the world.

India has also been a very active member of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project which involves input from more than 80 countries, including the 34 members of the OECD, all G20 members, and more than 40 developing countries. They are working on solutions to a challenge facing all countries – closing the gaps in the international tax rules that allow multinational corporations to legally but artificially shift profits to low or no-tax jurisdictions.

The BEPS project has lead to changes in the OECD Model Convention and the Transfer Pricing Guidelines, as well as recommendations for improvements to domestic legislations in all participating countries. These are soft law instruments, developed and agreed by the governments of participating countries, that will address double non-taxation and improve the mechanisms to address cases of double taxation. These action plans are now being implemented by all countries – OECD members, G20 members and developing countries – according to their legal and constitutional systems.

In this article, we have summarised a few significant changes that have been introduced by the Government of India aligning with its commitment to implement the BEPS action plans and to also establish a non-adversarial tax regime.

Modified assessment procedure

Until very recently, almost all companies engaging in international transactions were selected for a detailed TP scrutiny owing to a very low value based threshold. Further more than 50% of selected cases were facing transfer pricing adjustments at the hands of these TP officers – one of the highest averages in the world. It has also been analysed and documented that the taxpayers are vindicated in a majority of such transfer pricing litigation in higher appeal. Therefore this kind of an approach was causing a huge burden on the exchequer without a commensurate tax revenue generation while causing widespread concern in the litigating companies.

The CBDT has recently issued guidelines moving away from a simplistic value based threshold to a more sophisticatedrisk based audit through 'Computer Assisted Scrutiny Selection' system or under compulsory manual selection system on the basis of TP risk parameters. These guidelines further provide certain circumstances when a case can be selected for scrutiny in the event of non-applicability of TP risk parameters. In other situations, an opportunity of being heard has to be provided to the taxpayer before referring its case for TP audit. Post implementation of aforementioned guidelines, a significant decline in the cases referred for TP scrutiny has been observed in the past couple of years.

Update on 'Advance Pricing Agreement'

The introduction of Advance Pricing Agreement ("APA") in 2012 has been largely successful in helping large MNEs as well as the CBDT in transfer pricing dispute avoidance through a 'negotiation' based approach.

The APA refers to an agreement between the taxpayer and the tax authorities for determining the arm's length price ("ALP") or manner of determining ALP, for transactions with its associated enterprises ("AEs"). An APA can provide certainty to a taxpayer for up to 9 years (4 years' rollback plus 5 years under APA) which is enabling taxpayers to concentrate on businesses without the threat of having their international transactions aggressively taxed few years after the financial year has ended.The Indian APA programme has been appreciated nationally and internationally for being able to address complex TP issues in a fair and transparent manner. With the recent inking of three more unilateral APAs by CBDT with taxpayers during May - June 2018, takesthe total APA tally to 223 (203 Unilateral and 20 Bilateral).

New legislations around 'Secondary Adjustment'

The Finance Act, 2017 introduced the concept of 'secondary adjustment' with the objective to align the actual allocation of cashbetween taxpayer and its AE consistent with the transfer price determined as a result of 'primary adjustment', thereby removing the imbalance between cash account and actual profit of the taxpayer.Accordingly, it is no longer possible for tax payers to offer 'additional' tax on the transfer pricing adjustment off the books of accounts without incurring an annual interest on the difference not actually accounted for in the books and repatriation of cash to India.

A taxpayer is required to make secondary adjustment where the primary adjustment to transfer price has been made by –

- taxpayer, suo-moto in its return of income; or
- by assessing officer during assessment proceedings which has been accepted by the taxpayer; or
- under an APA entered into by the taxpayer; or
- as per the safe harbour rules; or
- as a result of resolution of an assessment by way of the mutual agreement procedure ("MAP") under agreement entered into under section 90 or 90A of the Income-tax Act, 1961 ("the Act") for

avoidance of double taxation.

Secondary adjustment kicks in only when the amount of primary adjustment made in aforesaid circumstances is not repatriated by the taxpayer's AE within the prescribed timelines. Such money, then is deemed as advanced made by taxpayer to its AE and interest thereon shall be computed as the income of the taxpayer in prescribed manner. Secondary adjustment shall be carried out only if the primary adjustment exceeds INR 1 crore.

Limitation of interest deduction – 'Thin Capitalization'

To combat cross-border shifting of profits through excessive interest payments and to safeguard the tax base of the country, the OECD, under its BEPS Action Plan - 4, has taken up the aforesaid issue which addresses BEPS risk arising from high leveraged investment mix. It recommends a disallowance of interest claimed by a taxpayer on debt to its AE, based on a fixed ratio rule, which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization ("EBITDA"). On these lines, the CBDT, in Finance Act 2017, has introduced a new Section 94B in the Act which provides as follows:

- Interest paid by an entity to its AEs shall be restricted only up to 30% of its EBITDA
- The provisions shall be applicable only when the amount of interest paid by taxpayers to its AEs exceeds INR 1 crore
- Disallowed interest shall be allowed to be carried forward for eight assessment years succeeding the assessment year for which the disallowance is first made

Computation of allowable interest in case of entities having negative EBITDA (i.e. in case of loss making entities); and treatment of amount of interest falling beyond 30% of EBIDTA and meeting the arm's length criteria simultaneously, are some of the issues wherein the CBDT has yet to provide clarifications.

Revised 'Safe Harbour' rules

Introduced in 2013, the original safe harbour rules hardly had any takers as compared to the phenomenal response to the APA programs. Taking a cue from the negotiations being done at the APA table, the CBDT moderated the Safe Harbour Rules in 2017 making them more palatable to the small and medium sized (SME) enterprises. Marked reductions in the threshold profit margin expectation from the IT-ITES global inhouse centres were reduced from 20% and 22% respectively to 17% and 18% respectively depending on the value thresholds. The new safe harbours are also available for transaction types including inter-company loans, KPO services, auto manufacturing, R&D, intra group services etc.

Safe harbours are also transfer pricing dispute avoidance mechanisms and aimed at bring the benefits of APA to SMEs on a self declaration basis. An APA entails filing fees and a relatively long and structured negotiation based engagement with the CBDT's team as against a safe harbour that runs on a self declaration basis subject to satisfaction of prescribed conditions.

A safe harbour is defined to mean those circumstances in which the income-tax authorities shall accept the transfer price declared by the taxpayer.

The move of making the safe harbour thresholds more palatable would also help the relatively small APA team focus on more complex and high value transactions.

Three-tiered' TP Documentation

In line with India's commitment to implement the recommendations of Action plan 13 of the BEPS project – Transfer pricing documentation and country by country documentation, India amended is income tax law to include Master File and Country by Country ("CbC") reporting effective from FY 2016-17.

In November, 2017, the Ministry of Finance, in its press release, set outthe final rules with respect to the new TP reporting obligations. The rules are largely inline with the Action Plan 13, but introduce certain elements that require taxpayers to specifically collate additional reporting just for India which is not required elsewhere in the world.

MNEs have recently completed their first year of the three-tiered documentation requirement mandated by many countries worldwide. The CbC Report, which contains country-wise aggregated data on MNEs' income, taxes and business activities, aims to equip tax authorities with the instruments needed to ensure that MNEs' profits are taxed where economic activities generating value and the corresponding profits are performed. The manner in which such sensitive data would be safeguarded and applied by tax authorities during audits was a serious concern for MNEs. The CBDT recently issued instructions (instruction# 2 of 2018)providing directions on the appropriate use of the CbC report and has clarified that the CbC report data will be used only for risk assessment procedures and cannot be the sole basis for making additions during audits by the TP officers.

Conclusion

With ever increasing globalisation in ways never before imagined (blockchain, crypto, digitisation, robotic process automation) diluting country barriers, ensuring and safe guarding countries against tax base erosion is only going to become more complex. Emerging economies especially India continues to bank heavily on tax revenue to fund its very large public services bouquet. At the same time, to secure employment and economic activity to achieve ambitious GDP growth targets, India needs to rapidly scale the ease of doing business in India ladder.

Rather than only banking on playing catch up with amending tax laws, governments especially India can focus on enabling their officers on keeping in step with the business than on policing using archaic tools. Bring in negotiation based multi year case closure at the first level of assessment having regard to business realities. Invite extensive engagement with the industry and learn from them on their ever changing business realities to develop a revenue approach that banks on collaboration.

The 'primary adjustment' to a transfer price, means the determination of transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of taxpayer.

CBDT vide Notification No. 52 of 2017 has issued rules to prescribe time limit for repatriation of the amount of primary adjustment and the method of computing the interest in case of delay.

BEPS: Base Erosion and Profit Shifting

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