Transfer Pricing In India: Recent Developments

Introduction

The economic reform measures taken by the Central government in 1990s, encouraged foreign investments into the Indian economy. Indian tax structure was highly simplified during that time as a measure of the economic reform. Indian government also took significant steps to avoid double taxation and thus shaped the national laws to give effect to the Double Taxation Avoidance Agreements ("**DTAA**").

To restrict the misuse of DTAA, Indian government introduced laws of Transfer Pricing ("**TP**") through the Finance Act, 2001, to the Income tax Act, 1961, ("**Act**") with effect from Assessment Year 2002-03.The motive of this TP Regulation is to strike all the international transaction made by companies to evade taxes by selling goods or service to Associated Enterprises ("**AE**"), established in tax heaven.

An International Transaction, under the TP Regulation is essentially a cross border transaction entered between AE in any sort of property, whether tangible or intangible, or in the provision of services, lending of money etc. Prior to the enactment of Finance Act, 2012, TP Regulations were only applicable to the international transactions. However, the Finance Act 2012 has increased the scope of the TP Regulations by extending the applicability of TP to Specified Domestic Transaction (**"SDT"**) through introducing of section 92BA to the Income Tax Act, 1961 ("**Act**"). Accordingly, the TP Regulation is made applicable to those domestic transactions which exceed aggregate value of INR 50 million in the relevant financial year.SDT include payments made to related parties (Section 297 of the Companies Act, 1956), inter-unit transfer of goods or services of profit- linked tax holiday-eligible units, transactions of profit-linked tax holiday-eligible units with other parties and any other transaction that may be notified by the Central Board of Direct Taxes.

Recently, vide Notification No. 41/2013 / F.No.142/42/2012 dated 10 June 2013, CBDT expanded the scope of TP Regulation by making it compulsory for the AE to disclose certain SDT along with international transaction; even if they did not result in profit accumulation.

Associated Enterprises and Arm's Length Price

It may be worthwhile to review AE and Arm Length Price ("**ALP**") for better understanding of TP Regulation. The basic criterion to determine an AE is to look into the participation in management, control or capital (ownership) of one enterprise by another enterprise. The participation may be direct or indirect or through one or more intermediaries. AE is defined under section 92A of the Act. The definition has two facets; first, enterprises which are regarded as ‘direct AE’ [section 92A(1)] and second, enterprises which are ‘deemed to be associated enterprises’ due to their indirect connection [section 92A(2)]

The arm's-length pricing states that, the amount charged by one AE to another for goods or services, in case of International transaction or SDT, must be the same, as if the parties were not related. An ALP for a transaction is therefore considered to be the price of that transaction had it been taken place in an open market.

The ALP is usually determined by six methods. The sixth method has been recently introduced. These six methods are: Comparable Uncontrolled Price Method (“**CUPM**”), Resale Price Method (“**RPM**”), Cost plus method (“**CPM**”), Profit Split Method (“**PSM**”), Transactional Net Margin Method (“**TNMM**”) and the Sixth method.

Methods 1-5 are similar to that mentioned under the OECD TP Guidelines. However, often the taxpayers encounter difficulties in applying the top 5 prescribed methods for certain transactions such as transfer of intangible, business restructuring, financial services transactions and cost contribution arrangements. Hence to simply the taxation laws, the Indian tax authorities allowed the Sixth method. Thereby the taxpayers now have the freedom to take recourse to any other methods, not described in the TP Regulation to establish prices.

Earlier, the TP Regulation provided that where more than one price is determined by the most appropriate method, the ALP shall be taken to be the arithmetic mean of such prices, or, at the option of the tax payer, a price which may vary from the arithmetic mean by an amount not exceeding 5% of such arithmetic mean. However, the Finance Act, 2009, amended the above provision, with effect from 1 October 2009, to provide that 5% variation should be applied with respect to the transaction price and not from the mean price. Subsequently, vide notification no. 30/2013 dated 15-4-2013, the CBDT revised the percentages of tolerance band for Financial Year 2012-13 for international transactions as well as SDT:

- 1% of the transaction price for wholesale traders;
- 3% of the transaction price in all other cases

Further, the Advance Pricing Agreement (**“APA”**) scheme was notified in pursuance to the Finance Act, 2012, vide Notification No. 36 of 2012 dated 30 August 2012. An APA is an agreement entered between a taxpayer and at least one tax authority concerning the applicability of TP Regulation to a taxpayer's inter-company transactions. This agreement is usually entered for multiple years. Through the APA, the tax authority accepts not to look for a TP adjustment for enclosed transactions as long as the taxpayer obeys to the terms and conditions as agreed by the APA.

It is pertinent to mention that from April 2009, the CBDT has been empowered by the Government to formulate Safe Harbour Rules ("**SHR**"). SHR will specify the circumstances in which the tax authorities will accept the ALP, as declared by a taxpayer, without detailed scrutiny. However, till date no such rule has been issued by the CBDT.

Further, TP in Research and Development (**"R&D"**) is an important issue to be addressed. The CBDT recently aimed to settle the dispute that arose due to the view taken by tax authorities that R&D contract is a profit gaining method and thereby it must be considered as a taxable event. CBDT vide two circulars, aimed to clarity issues of TP in relation to R&D activities both in terms of characterization of contract R&D services and application of the profit split method in appropriate cases. Also, CBDT vide Circular No. 3 of 2013, issued guideline prescribing characterization of contract R&D service. This circular prescribes five tests which need to be cumulatively satisfied in order to characterize R&D centers of foreign enterprises as contract R&D centers.

<u>Recent Cases</u>

It is to be noted that TP issues are sometimes prone to litigation also. The Mumbai Bench of the Income-tax Appellate Tribunal ("**ITAT**") recently held that for a transaction to be subject to TP Regulation, under the category of "deemed international transaction", it must be proved beyond doubt that the transaction is an "international transaction".[1]

Further, the Hyderabad Bench of the ITAT held that investments made by the taxpayer in its foreign subsidiaries are not in the nature of "transactions". Therefore TP Regulation will not be applied to such transactions.[2]

Also, the Delhi High court in the case of Maruti Suzuki India Ltd made observations on proper opportunity to be provided by tax authorities before taking any adverse decision and on the determination of the arm's length price of intangible in the form of trademark.[3] The court in the instant case allowed the Writ Petition and stated that deduction can be claimed for the expenses incurred on advertisements. Further the Court also laid down certain rules which need to be fulfilled in order to apply 'bright-line' test.

The recent ruling of Maruti Suzuki India Limited raised the debate of whether Indian company can claim compensation of the amount that has been spent by the foreign AE with respect to marketing and other advertisement. Though the issue of marketing intangibles has been settled by the said judgment but a number of litigation is expected on this issue.

1. *Kodak India Pvt. Ltd. v. ACT* ITA No. 7349/Mum/2012.
2. *Vijai Electricals Ltd. v. ACIT* IT(TP)A No. 842/HYD/2012.
3. Maruti Suzuki India Limited vs. Addl. Commissioner of Income Tax, TPO, New Delhi, W.P. (C) 6876/2008.

Clarification on Multi Brand Retail

Previously investment up to 51% was allowed only in single brand retail ("**SBR**") and that to under the Approval Route. Foreign direct investment ("**FDI**") in multi-brand retail ("**MBR**") was prohibited. However, pursuant to **Press Note 4 of 2012**, 100 % FDI is made permissible under SBR with the approval of FIPB, subject to certain condition. One such condition is that the investment must be over 51% and at least 30% of the value of the product sourced, must be sourced from India, preferably from micro, small and medium enterprises and local artisans or craftsman.

Further by virtue of **Press Note 5 of 2012**, FDI in MBR was made permissible up to 51%, subject to fulfillment of certain condition. One such condition is that the minimum investment required is USD 100 million and the retail sales outlet must be only within cities which have a population of 10 lakhs or more. Furthermore 30% of the value inputs must be sourced from small industries [defined to mean Indian suppliers with investment of less than USD 1 million]. Additionally 50 % of the FDI must be invested in backend infrastructure (excluding land and rentals).

Subsequently, the Department of Industrial Policy and Promotion ("**DIPP**"), Govt. of India, issued the Consolidated FDI Policy effective from 5th April 2013 consolidating the directions issued under the Press Note 4 & 5 of 2012.Following the permission of FDI in MBR, the DIPP was showered with several queries from various companies. In response to those queries, the DIPP issued clarification on FDI policy**for MBR** trading. Below mentioned is the list of clarifications issued by the DIPP with regard to the FDI Policy 2013.

Clarification

Small and medium enterprises (SME): According to the clarification issued by the DIPP, the phrase 'small industries' includes SME having maximum investment of USD 1 million in Plant & Machinery. The DIPP also stated that the Certificate issued by District Industries Centre would be considered to be an adequate authentication to confirm the status of supplier as 'small industry'. Further DIPP clarified that the requirement of 30% sourcing [*at least 30% of the value of procurement of manufactured / processed products purchased shall be sourced from Indian 'small industries'*] will be calculated only with reference to the sale of such goods in the front end stores and shall not be allowed to be distributed by any means, other than through the front end stores.

Investment in back end infrastructure: The clarification stated that the entire investment in back end infrastructure by the MBRT entity, mandated by the FDI Policy, must be done through separate entity and buying the existing back-end infrastructure in India will not be permitted. However, the DIPP permitted such back end infrastructure to be established in non FDI approved states. The clarification clearly stated that the investment must be made in Greenfield assets and therefore foreign investor will not be allowed to buy existing back-end assets or acquire stakes in companies engaged back-end infrastructure or invest in equity of a company engaged in developing back-end infrastructure or by any other similar means, to meet the 50% investment criteria.

Further, vide the Clarification, the government also prohibited MBRT from undertaking wholesale activity by providing supplies to related or third party companies, as this would amount to wholesale trading/cash and carry trading. The Clarification also provides that retailing in any form is to be through the front end stores only and such front end stores will have to be company owned and company operated only by the MBRT entity.

Franchisee agreement: The DIPP clarified that the franchisee model is not permissible for MBRT entities and the front end stores set up by MBRT entity will have to be 'company owned and company operated' by the MBRT entity.

Miscellaneous: In addition to the above mentioned clarifications, the DIPP also clarified certain queries which are discussed under this category. Vide clarification DIPP kept its reliance confined to only the Census data for determining the population of a city and rejected any form of self certification proposed by the investors. With reference to States discretion to make laws regarding FDI, the DIPP clarified that the power to change the fundamental rule rests upon the Central Government. However, States are entitled to make minor modifications which will be binding upon the investors. Further the DIPP strictly prohibited MBR entity from engaging in any sort of e-commerce activity.

Conclusion

The clarifications were long awaited by the investors. However, the Clarification issued by the DIPP is only given with regard to the MBR entities, avoiding the SBR segment. Despite the government approval issued 10 months back with regard to the FDI in MBR, investors are showing their apathy in entering India’s MBR sector. However, recently a high-level inter-ministerial panel headed by the Secretary of department of economic affairs, Mr. Arvind Mayaram suggested DIPP to increase the FDI limit in MBR from 51% to 74%. The new pro-active approach by the Government will surely boost the investors confidence.

SEBI (Issue And Listing Of Non-Convertible Redeemable Preference Shares) Regulations, 2013

SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013 have been notified on June 12, 2013. The said Regulations provide for a comprehensive regulatory framework for public issuance of non-convertible redeemable preference shares and also for listing of privately placed redeemable preference shares. Further, as per Basel III norms, Banks can issue non-equity instruments such as Perpetual Non-Cumulative Preference Shares and Innovative Perpetual Debt Instruments, which are in compliance with the criteria specified by RBI for inclusion in Additional Tier I Capital. The Regulations shall also be applicable to such instruments issued by banks. The said regulations is available at

http://www.sebi.gov.in/cms/sebi_data/attachdocs/1371190341311.pdf

News 10 @ a glance

State governments taking action against Ponzi Schemes

Due to the increase in sham deposit companies throughout India, the state governments of West Bengal, Assam and Odisha, states which did not have any legislation to protect the depositors from ponzi schemes, have moved protection of Interest of depositors in Financial Establishments Bills for presidential assent. These legislations are to empower the authorities to attach or confiscate money and property of the guilty companies as well as the directors or promoters of such companies in order to refund the depositors in a systematic manner.

Companies suspended for failing to comply with the minimum 25% public holding norm

Existing listed private sector companies are required to achieve and maintain minimum public shareholding of 25% as per the SCRR rules by 3rd June 2013 and the public sector companies have time till 8th August 2013 to achieve a minimum public shareholding of 10%.

33 companies out of 108 non-compliant companies have been suspended by the stock exchanges. Whereas SEBI has passed an ad interim order against the promoters /directors of 105 defaulting companies freezing their voting rights and corporate benefits. Further the promoters of these defaulting companies have also been barred from dealing in the market or to holding any new position on boards of listed companies.

Public sector entities can enter into the Banking business

Private as well as public sectors entities are eligible to set up a bank through a wholly-owned non-operative financial holding company (NOFHC). RBI has clarified in this regard that, a business group with a minimum paid up equity capital of Rs. 500 crore can apply for a license.

As per the new norms a banking entity has to establish 25% of its branches in unbanked rural areas with population up to 9,999. Thus companies which primarily run business in rural areas will have an edge over other companies. Also there will be an automatic conversion of the existing NBFC branches into bank branches for tier 2 to 6 centers.

Supreme Court says yes to POSCO iron ore mining license

The Supreme Court has set aside a 2010 order of the Orissa High Court that had quashed the state government's recommendation of allotting a prospecting licence for the Khandadhar iron ore mines in Sundergarh district to the steel giant POSCO. Nevertheless the world's fourth-largest steel producer still has to overcome many obstacles before it can lay its hand on the recommended captive iron ore deposit, crucial to its proposed 12-million-tonne plant near Paradip, as the project has been vehemently opposed by several activist groups and localities on grounds of forced land acquisition, violation of Mineral laws, imbalance of ecology and other environmental issues.

Cement Manufacturers have to pay 10% of the penalty slapped by COMPAT

Competition Commission of India (CCI) imposed a penalty of Rs. 6,200 crore on 11 cement manufacturing companies for allegedly forming a cartel to manipulate the market price of cement on 20 June, 2012. Thereafter 4 out of those 11 companies challenged a COMPAT interim order asking all 11 cement manufacturers to deposit 10% of the penalty. The Supreme Court has ordered them to deposit the same.

Government willing to have an out of court settlement in Vodafone tax dispute

The Union Cabinet has approved the initiation of “non-binding” conciliation proceedings with Vodafone with respect to a long disputed tax claim. Whereas Vodafone has written to India's Central Board of Direct Taxation to request more time to reply to a conciliation offer. In January, 2012 the Supreme Court had dismissed the Income Tax department’s claims against Vodafone, holding that Revenue lacked the “territorial tax jurisdiction” to tax the Vodafone’s purchase of a 67% stake in Hutchison Essar. Thereafter the government had brought into an amendment allowing taxation of cross-border transactions with retrospective affect and thus Vodafone is facing a tax demand notice of Rs. 11,200 crore from the Income Tax Department despite of having a Supreme Court ruling in their favor.

PIL against RANBAXY PHARMA dismissed by the Apex Court

In a PIL seeking a probe against Ranbaxy Pharma for allegedly manufacturing & selling substandard medicines in India has been dismissed by the Supreme Court by reason of lack of evidence.

Also, the Bench pointed out that the entire arguments of the petitioner were based on US judgment, which is out of our jurisdiction & thus, the plea can't be decided on its basis.

Plea against special court's jurisdiction by ESSAR, LOOP rejected by the Supreme Court

The plea of these telecom companies for being tried only under a magistrate as against other accused of 2G case & not by the special CBI court for they have been charged under Section 420 & Section 120B of the I.P.C & not under the Prevention of Corruption Act has been dismissed by the Supreme Court declaring it to be meritless

PIL on US surveillance of internet data in India dismissed

PIL filed by Prof. S. N. Singh, in the SC, seeking directions to the Union government to take all adequate steps against the US surveillance on Indian citizens was dismissed by a bench of Justice A. K. Patnaik and Ranjan Gogoi, saying that the court has no jurisdiction over the US government. However the petitioner has been given a liberty to approach any other appropriate authorities for the relief he looks for.

Public Trust Petition for government scheme dismissed by Bombay High Court

The review petition filed by Shri Shiv

Seva Medical Foundation seeking review of the court’s earlier order approving a 2006 scheme that required public trusts getting government aid or land to provide free hospital beds for the poor and underprivileged has been rejected by the Bombay high court. A division of bench of Justices Sadhna Jadhav and V. K. Tahilramnaj rejected the petition saying ‘the scheme is formulated in the need for modification of Section 41A in the larger interest of the society & thus should not be interfered.