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TRANSFER PRICING REGULATIONS AND ADVANCE PRICING AGREEMENTS IN INDIA

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ABSTRACT

The Indian Transfer Pricing provisions require all international transactions and Specified Domestic Transactions undertaken by an enterprise with its Associated Enterprises are to be computed having regard to the Arm's Length Price. This paper has discussed in brief the transfer pricing methods prescribed for computation of the arm's length price. Further, the paper covers the concept of Advance Pricing Agreement and some of the recent additions/amendments in the TP Regulations.

KEYWORDS
transfer pricing, transfer price, arm's length price, advance pricing agreement (APA), transfer pricing methods.

TRANSFER PRICING IN INDIA

Transfer Pricing (TP) is one of the most debated topics around the world, particularly in India. The key focus of the Revenue authorities is on the transfer prices of intra-group transactions of the multinational enterprises who undertake majority of the international trade.

When two related entities enter into any cross-border or domestic transaction, the price at which they undertake the transaction is called Transfer Price. The price between unrelated parties in uncontrolled conditions is known as the "Arm's Length" price (ALP). The transfer pricing issue arises because the transfer price which is transacted between the two related entities may be different than the price that would have been agreed between two unrelated entities.

As per Section 188 of the Companies Act, the expression "arm's length transaction" means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest. The Companies Act and the accompanying rules do not provide any guidance/detailed process on the methodology for determination of the arm's length nature of related party transactions. However, the transfer pricing provisions under IT Act provides detailed process to determine whether a transaction is at arm's length.

TRANSFER PRICING LEGISLATION IN INDIA

Transfer Pricing Regulations were introduced in the year 2001. They are largely based on the OECD (Organisation for Economic Co-operation and Development) Transfer Pricing Guidelines. They are enshrined in Income Tax Act, 1961 ('Act') and Income Tax Rules, 1962 ('Rules').

There is a separate code on transfer pricing under Sections 92 to 92F of the Indian Income Tax Act, 1961 with Rules 10A to 10E of the Rules, that covers intra-group cross-border transactions, which is applicable from 1 April 2001 and specified domestic transactions which is applicable from 1 April 2012.

The Companies Act, 2013, with effect from 1 April 2014, require companies to comply with certain statutory requirements in connection with the transactions entered into by a company with its related parties. The management, directors and committees of the board are, therefore, responsible for identification, approval and disclosure of related party transactions undertaken by the Company. Further, Section 188 of The Companies Act governs and regulates the related party transactions undertaken by a company.

Section 2(76) of The Companies Act provides the definition of a related party. "Related party" with reference to a company means any of the followings:

- a director or his relative;
- a key managerial personnel or his relative;
- a firm, in which a director, manager or his relative is a partner;
- a private company in which a director or manager is a member or director
- a public company in which a director or manager is a director or holds along with his relatives, more than two per cent of its paid-up share capital;
- any body-corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;
- any person on whose advice, directions or instructions a director or manager is accustomed to act;
- any company which is a holding, subsidiary or an associate company of such company; or a subsidiary of a holding company to which it is also a subsidiary.

Further, the Companies Act, under Section 2(77), provides the definition of "Relative". A relative includes members of a Hindu Undivided Family; husband and wife; or Father (including step father); Mother (including step mother); Son (including step son); Son's wife; Daughter; Daughter's husband; Brother (including step brother); or Sister (including step sister).

In June 2015, The Ministry of Corporate Affairs via its notification, have excluded related parties of private companies as mentioned under Section 2(76)(viii) of the Cos. Act from the applicability of the provisions of Section 188 of the Cos. Act. Accordingly, intercompany transactions entered into between holding company, subsidiary company, associate company and fellow subsidiary in case of private companies shall not be subject to the provisions of Section of 188 of the Cos. Act.

TRANSFER PRICING METHODS AND THEIR APPLICATION

The TP regulations clearly lay down the scope and purview of Indian Transfer Pricing legislation. It defines basic terms such as Associated Enterprise ("AE") and International Transaction. It has also listed various methods to be considered for determination of the arm's length price. Section 92A defines an AE. An "AE", in relation to another enterprise, means:

- an enterprise which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

According to Section 92B, an International Transaction means "transaction" between two or more associated enterprises, either or both of whom are non-residents, in the nature of the following:

- Purchase, sale or lease of tangible or intangible property;
- Provision of services;
- Lending or borrowing money; or
- Any other transactions affecting profits, losses, income, assets or liability of the enterprise.

As per the Indian TP regulations, the income arising from an international transaction with an AE must be computed having regard to the arm's length price. The calculation of the arm's length price has to be done by using the Most Appropriate Method (MAM). The most appropriate method must be selected from the following six methods as listed under the regulations:

1. COMPARABLE UNCONTROLLED PRICE METHOD ("CUP METHOD")

The CUP is one of the most direct, reliable and preferred method of determining the ALP. It seeks to determine the arms' length price by comparing the controlled transaction with the uncontrolled transaction. The "uncontrolled transaction" means the transaction between enterprises other than associated enterprises, whether resident or non-resident. This method is generally used where there is a strong similarity of products or services.

2. RESALE PRICE METHOD ("RPM")

This method is used in case of purchase of goods or services from related parties for resale to unrelated parties without substantial value addition. The price is reduced by the normal gross margins earned by unrelated party for same or similar products or services. In order to apply this method there is a need for similarity of functions performed and risks undertaken. In this method, Gross margins are used as the profit level indicator.

3. COST PLUS METHOD ("CPM")

CPM Method is used in cases that involve transactions such as manufacture, assembly or production of tangible products or services that are sold or provided to related parties. Similar to RPM method, such method also demands high similarity in functions performed and risks borne. The mark up on direct and indirect costs incurred to be based on unrelated comparable. Gross margin is used as the profit level indicator.

4. PROFIT SPLIT METHOD ("PSM")

The PSM is normally used in multiple international transactions, which are so closely inter related that they cannot be evaluated separately for determining the arm's length price. This method would require identifying the combined profit or loss of the related parties to be split between them. The profit split method is normally used in situations where both parties to a controlled transaction own valuable, non-routine intangible assets. This method is slightly complex in nature and hence, sparingly used.

5. TRANSACTIONAL NET MARGIN METHOD ("TNMM")

Under this method, the standards of comparability are less stringent relative to the other methods. Only broad similarity of functions is required. This method compares the normal net profit margin, computed in relation to costs incurred or sales effected or assets employed or having regard to any other relevant base, realized from transactions with the AEs to the net profit margin realized by unrelated enterprises from comparable uncontrolled transactions. This method is most widely used and considered as a practical method.

6. ANY OTHER METHOD ("AOM")

The Central Board of Direct Taxes vide Notification No. 18/2012 dated May 23, 2012, prescribed sixth TP Methods for computation of ALP. For this purpose, Rule 10AB was inserted under the Income Tax Rules, 1962.

This AOM evaluates the arm's length nature of the international transaction by considering the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances.

SELECTION OF THE MOST APPROPRIATE METHOD

Rule 10C(2) of the Rules, lists the factors that should be taken into account in selecting the most appropriate method. Some of the factors are the availability, coverage and reliability of data necessary for the application of the method and the nature, extent and reliability of assumptions required to be made in application of a method.

In practice, application of CUP method is very difficult as very high degree of comparability is required. It is also difficult to apply the RPM and CPM methods because the gross margin of the comparables is generally not available. Therefore, TNMM is most widely method.

TRANSFER PRICING DOCUMENTATION

Under Section 92D, Rule 10D, there is a prescribed list of documents required to be kept and maintained by the companies entering into an international transaction. However, this mandatory documentation requirement is applicable only in a case where the aggregate value of the international transactions entered in the books of account exceed one crore rupees.

The law under Rule 10D(1), mandatorily requires to maintain the following documents: Description of Ownership Structure; Profile of Multinational Group; Description of Business; Nature & Terms of Transactions; Description of Functions, Risks & Assets Record of Economic & Market Analyses; Comparability Analysis; Record of Uncontrolled Transactions; Description of Methods considered; Record of actual working assumptions, policies, price negotiations; any other information, data or document that is company specific information.

ADVANCE PRICING AGREEMENT ("APA")

APA was introduced in the Finance Bill 2012. Two sections - 92CC and 92CD under the Act, were inserted to provide a framework for Advance Pricing Agreement. An APA is an agreement between a taxpayer and a taxing authority to determine the ALP or specify the manner or methodology in which ALP shall be determined for a set of transactions over a fixed period of time. Once agreed upon, the APA agreement shall be a binding on the persons who have entered into (includes commissioner and his subordinates) and also valid for a period of five consecutive previous years. However, APA shall not be binding on the Board or the taxpayer if there is a change in any of the critical assumptions, change in law or any request from competent authority of other country in case of bilateral and multilateral agreements.

For unilateral APA, the application is to be made to Director General of Income-tax (International Taxation) ("DGIT") and in case of Bilateral and Multilateral APA, to the Indian Competent Authority ("Indian CA"). It is mandatory to go for Pre-filing consultation, which shall determine the scope of agreement, identify the TP issues, determine the suitability of the international transaction for the agreement and discuss the broad terms of the agreement. The process shall not bind either of parties to enter into APA. Before finalization of the APA, it is possible to amend the terms of APA or withdraw the entire application.

There is a prescribed amount of fees payable at the time of making the application for APA. The fee depends upon the amount of international transaction entered into or proposed to be undertaken in respect of which an agreement is proposed. In case the amount of proposed international transaction does not exceed Rs.1,000 million, the fees prescribed is Rs.1 million. For amount of less than Rs. 2,000 million, there is a fees of 1.5 million and for amount over Rs. 2,000 million, the fees is RS. 2 million.

As per the compliance requirements, the taxpayer is required to furnish Annual Compliance Report to DGIT for each year. The Transfer Pricing Officer shall carry out compliance audit for each year and provide report to DGIT/ Indian CA regarding the compliance by taxpayer with terms of the APA. In case of failure to comply with the terms of the agreement or to file the Annual Compliance Report in time, the board has the power to cancel the APA.

The Finance (No. 2) Act, 2014, has provided for 'roll back mechanism' in section 92CC of the Act under the present APA scheme which refers to the applicability of the methodology of determination of ALP, or the ALP, to be applied to the international transactions which had already been entered into in a period prior to the period covered under an APA. This roll back mechanism is effective with effect from 01-10-2014.

AMENDMENTS IN TP DOCUMENTATION

The Finance Minister in the Budget 2016, proposed to introduce three layered transfer pricing documentation requirement, to be effective with effect from AY 2017-18. They are based on recommendations issued by the OECD and G-20's -Base Erosion and Profit Shifting ("BEPS") Action Plan 13. As per the requirements, the taxpayers will now be required to prepare a master file, local file and country by country reporting referred as (CbCR). A Master File is required to provide an overview of the Multinational Enterprises (MNEs) business and explain the MNE's TP policies in the context of its global economic, legal, financial and tax profile.

A Local File shall demonstrate that the taxpayer has complied with the arm's length principle in its material intra-group transactions. CbC Reporting will provide information to tax authority to enable it to undertake a TP risk assessment. The detailed contents of these documents are provided in the rules.

The CbCR is applicable only for large taxpayers, that is, taxpayers having an annual consolidated group turnover of over €750 million in the immediately prior year. The new regime will be applicable for financial year (FY) 2016-17. The first filing will be due by 30th November, 2017. For the FY 2016-17, this requirement is applicable for taxpayers having a group consolidated turnover of approximately INR 53,950 million for FY 2015-16. Indian resident parent companies will be required to file the master file, local file and CbCR with Indian tax authorities. For Indian subsidiaries with parent companies resident outside India, the CbCR will ordinarily be filed by the parent entity in their home country or by a designated entity in its home country.

CONCLUSION

India is strongly committed to have a stable and predictable tax regime. The year-on-year amendments in the TP rules and regulations are aimed towards simplification and rationalization of our taxation system. The efforts are undertaken to bring clarity over the complex and controversial issues in order to reduce the TP Litigation matters. The adoption of maintenance of Master file, Local file and CbC reporting will definitely reveal a lot of information about the functioning of transactions between the related parties. The enterprises involved in related party transactions are indeed expected to follow the TP policy diligently and comply with the rules and regulations to avoid paying penalties.

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