

Analysis

India's Final Transfer Pricing Rules

BY SAMIR GANDHI*

India's transfer pricing rules,¹ issued Aug. 23 as rules 10A to 10E, remove some of the anomalies and concerns of the draft rules,² and contain a few surprises.

Noteworthy among the changes are:

- Preference for traditional methods in the draft rules has been abandoned with the taxpayer being able now to select the "most appropriate" method.
- The resale price method, with some adjustments, can now specifically be used to price services.
- An earlier requirement that transfer prices must be confirmed by a third method if two methods can be applied as the most appropriate method has been dropped.
- And, of great interest, is new wording concerning a taxpayer's audit report that seems to suggest that the concept of arithmetical mean has been diluted and that the tax authority, at least in principle, may be more open to the concept of ranges than previously had been thought.

Most Appropriate Method

(Rule 10B & Rule 10C)

The final rules set forth five prescribed transfer pricing methods, following Organization for Economic Cooperation and Development norms:

- comparable uncontrolled price (CUP);
- resale price (RP);
- cost plus;
- profit splits (PS); and
- transactional net margin method.

The description of methods uses similar terminology for key concepts, e.g., property, services, international transactions, etc. However, the final rules do contain some key changes regarding definitions.

The terms, "gross profit margin" and "gross markup," have replaced the term, "normal profit margin," under the resale price and cost plus methods. The government also will allow use of the resale price method in cases involving related-party services. However, when the resale price method is applied, the final rules require adjustments to the adjusted price after applica-

tion of the gross profit margin to account for functional and other differences, including differences in accounting practices.

This is not strictly in accordance with internationally accepted practices, wherein such differences are required to be taken into account by making adjustments to the gross profit margin. In fact, when applying the cost plus method, the relevant subrule requires such adjustments to be made to the gross markup and not to the adjusted price. Costs will include both direct and indirect costs when applying the cost plus method.

Profit splits also can be applied to transactions involving unique intangibles. While applying the methods, comparability of transactions will be judged by considering the laws and government orders in force. For example, taxpayers will have to factor in the effects price controls on drugs or regulations that govern currency exchanges.³ This is a welcome move as the regulations affect the price and margins of a transaction.

Aggregation of Transactions

The final rules will allow transactions to be aggregated, which is recommended by the OECD transfer pricing guidelines and is included in most countries' transfer pricing rules. Most Indian tax officials already have accepted the practice, and are allowing taxpayers to bunch or aggregate similar transactions entered into in a financial year to compare results with those of similar uncontrolled transactions entered into by the taxpayer and a third party and those entered into by unrelated parties.

This concept has been incorporated at relevant places for the determination of an arm's-length price under various methods. The earlier draft rules have been modified as well to address concerns on whether taxpayers had to compare every related-party transaction with a third-party transaction.

Use of Multiple-Year Data

While comparing a transaction or a group of transactions, use of multiple year data has been specifically allowed. Taxpayers can benchmark transactions of a particular financial year by comparing it to earlier financial year data.

The regulations state that taxpayers are required to rely on data relating to the relevant financial year for comparisons. However, taxpayers also have been given an option to use data for the two previous years in cases where such data have an influence on determining transfer prices.

³ India has the Drug Price Control Order (DPCO) and Exchange Control Regulations.

¹ Notification No. S.O. 808 (E) dated Aug. 21, 2001

² The draft rules were issued in May (10 *Transfer Pricing Report* 327, 9/19/01).

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Internationally, an acceptable practice for comparing transactions is to use multiple year data ranging from three to five years to remove the effects of business cycles, changes in economic conditions, etc.

Preference for Methods

The draft rules stated that the government had a preference for traditional methods (CUP, cost plus, and resale plus). But this priority for transactional methods was eliminated from the final rules. Accordingly, the taxpayer can now select the "most appropriate method" under Indian Tax Code Section 92C read with Rule 10C of the Income Tax Rules.

The final rules also have removed a requirement in draft rules that would have required taxpayers to confirm their transfer pricing results by applying a third method in cases where two methods could be applied as the most appropriate method.

Arithmetic Mean vs. Range of Price

The regulations discussed in Section 92C require computation of an arithmetical mean if more than one arm's-length price is found through the application of one of the prescribed methods. Yet this has not been addressed very specifically in the final rules. However, the rules require that annexes to the taxpayer's audit report disclose the consideration involved in a transaction to be determined **with regard** to the arm's-length price.

One can argue that this phrase suggests that the concept of range of price is being accepted by the authorities, at least in principle. The view is further strengthened, by the Circular No. 12, dated Aug. 23, 2001, which bars tax authorities from making adjustments to the taxpayer's arm's-length price if the transfer price is not 5 percent less or 5 percent more than the price determined by the assessing officer.⁴

By allowing a range, the concept of arithmetical mean is diluted. However it would have been advisable for the concept of a range of arm's-length results to be incorporated in the final rules because, from a practical standpoint, benchmarking exercises tend to create a range of results, all of which are at arm's length.

The above concept can be explained by way of example as follows:

A Ltd, after undertaking a benchmarking analysis, arrives at a result after application of the CUP method with respect to a particular international transaction involving an import.

Transaction value of A Ltd	Rs. 15
Comparable CUP's available	
B Ltd	Rs. 10
C Ltd	Rs. 12
D Ltd	Rs. 14
E Ltd	Rs. 16
Arithmetical mean of the arm's-length prices	Rs. 13
$(Rs. 10 + Rs.12 + Rs.14 + 16)$	
$\frac{\quad}{4}$	
Arm's-length price after application of 5% tolerable range	Rs. 12.35 to Rs. 13.65

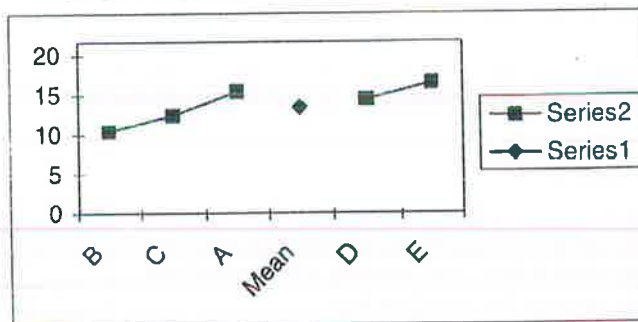
⁴ Circular No. 12 appears in the Text section.

Adjustment to A's income
(Rs. 15 – Rs 13.65)

Rs. 1.35

However, if the range concept were to have been followed, the price of A Ltd would have fallen within the arm's-length range of Rs. 10 to Rs. 16 leading to compliance with the arm's-length principle.

A graphic representation of the same is:



The application of methods were to become clearer if the authorities would give illustrative examples under each method to guide taxpayers.

Documentation

(Rule 10D)

Final documentation requirements have removed concerns expressed earlier on the onerous obligations imposed on the taxpayer to maintain details of all associated enterprises, commercial agreements, etc.⁵

The final rules require that the above details relating to associated enterprises, terms and conditions of transactions, etc. be kept only for the international transaction entered into by it. Following criticism from practitioners, the government also changed the documentation rules, dispensing with the requirement to obtain accounts of foreign affiliates and the tax treatment applied by foreign tax jurisdictions to matters relevant to the international transaction. The government also removed overlapping clauses by grouping common requirements.

Relevant Rule 10D lists 13 items for the purpose of documentation. However, these items can be classified as follows:

- description of the group (ownership structure and description of business and industry etc.);
- description of the international transactions;
- functional analysis (functions performed, assets employed, risks assumed);
- assessment of comparables; and
- selection and application of most appropriate method.

Databases

In accordance with acceptable international practices, documentation must be maintained for eight years and should be contemporaneous as far as possible. The databases used do not necessarily have to come from the country of residence of the associated

⁵ See Verma, Dinesh, "Documentation Under India's Transfer Pricing Law, Rules" (10 *Transfer Pricing Report* 398, 10/3/01).

enterprises, but can pertain to any country. This means a taxpayer can compare a transaction with an enterprise situated in the United Kingdom with databases available in similar geographical markets, e.g., Germany or France.

Transitional Provisions

The regulations for determining an arm's-length price (section 92 to 92F) apply to international transactions entered into on or after April 1, 2001. The government has clarified in the circular that no adjustment will be made under the provisions of section 92C(3) for failing to maintain or submit documentation for the transactions entered into between April 2001 to August 2001. However, from a practical point of view, this relaxation offers little comfort as the taxpayer is still required to conform to an arm's-length price. The relaxation is only for not maintaining documentation, not for failing to conform to the arm's-length principle.

Obligation to Make an Adjustment?

A newly inserted clause (Rule 10D(1)(l)) requires details of any adjustment made to the transfer pricing involved in an international transaction to correspond with the arm's-length price as determined under the final rules' methods and the consequent adjustments to total income.

This may mean that the authorities will require a taxpayer to make self-adjustments to the income returned, according to the books of accounts, when a transaction value does not correspond to an arm's-length price. However, the issue of whether the authorities will allow downward adjustment (e.g., sale price of exports higher

than an arm's-length price) to the return of income is still being debated.

Audit Report (Rule 10E)

An accountant's report, on Form 3CEB, is required that gives the accountants opinion on the taxpayer's maintenance of prescribed documentation. The audit report also must contain detailed information, such as listing associated enterprises with which cross-border transactions have been entered into; descriptions of the transactions—broken down under separate headings for tangible property, intangible property, services, funds, and cost contribution arrangements.

Conclusion: Going Forward

India has finally entered the competition among tax authorities to share the global tax pie by introducing a detailed statutory transfer pricing framework. The transparency shown by the authorities on the introduction of the transfer pricing regulations is a welcome feature of our domestic law. Experiences in other countries have shown that continuous interaction with the taxpayers and professionals by a receptive administration can lead to a fair and equitable transfer pricing regime.

Since the regime has been introduced for the first time in India, the authorities should explain the gamut of the regulations and rules by way of further administrative circulars.

A taxpayer should review the existing transfer pricing policies and should take a risk assessment review of the same. A detailed transfer pricing study will be required to establish conformity with arm's-length principle.

