### 10.3. Emerging Transfer Pricing challenges in India

### 10.3.1 Transfer Pricing Regulations in India

10.3.1.1. The Indian TP regulations are based on arm's length principle. The regulations came into effect from 1 April, 2001. The regulations provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price (ALP). The concept of associated enterprises has been defined in detail in the regulations.

10.3.1.2. The ALP shall be determined by any of the prescribed methods The methods prescribed for the determination of arm's length price are the Comparable Uncontrolled Price method, Resale Price method, Cost plus method, Transactional Net Margin method, the Profit Split method and a residual method known as "any other method" appropriate to determine the arm's length price under the statute. The regulations do not provide any hierarchy of the methods and support concept of "most appropriate method" which provide the most reliable measure of an arm's length result under a particular set of facts and circumstances.

10.3.1.3. The regulation prescribes mandatory annual filing requirements as well as maintenance of contemporaneous documentation by the taxpayer in case international transactions between associated enterprises cross a threshold and contains stringent penalty implications in case of non-compliance. The primary onus of proving arm's length price of the transaction lies with the taxpayer. Indian transfer pricing administration prefer Indian comparables in most of the cases and also accept foreign comparables in cases where foreign associated enterprises is less or least complex entity and requisite information are available about tested party and comparables.

10.3.1.4. In order to provide uniformity in application of transfer pricing law there is a specialized Directorate of transfer pricing to administer transfer pricing rule under supervision of Director General of Income tax (International Taxation). Transfer Pricing officers (TPO) are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath, on-the-spot enquiry/verification and compelling the production of books of account and other relevant documents during the course of a transfer pricing audit. A dispute resolution panel (in short DRP) is available to taxpayer to resolve disputes relating to transfer pricing before disputes of final order by Assessing Officer, (which incorporates the order of TPO).

### 10.3.2. Key Current and Emerging TP Audit Issues in India

Indian transfer pricing administration over the past 10 years has witnessed several challenges in administration of transfer pricing law. In the above backdrop, this chapter highlights some of the emerging transfer pricing issues and difficulties in implementation of arm's length principle.

### 10.3.3. Challenges in the comparability analysis

10.3.3.1. General: India believes that comparability analysis is key to determine arm's length price of international transaction. However, increased market volatility and increased complexity in international transaction have thrown open serious challenges to comparability analysis and determination of arm's length price. Some of these challenges and responses of Indian transfer pricing administration in dealing with these challenges have been analyzed below.

10.3.3.2. Use of contemporaneous data: Commodity price volatility, debt, recession and worries have brought volatility to world market. The volatility impede a stable business environment and result in fluctuation in margins of MNEs and their subsidiaries. In this context, use of contemporaneous comparables provides a more accurate arm's length price in a particular year.

10.3.3.3. Application of data rules: The Indian transfer pricing regulation stipulates that data to be used in analyzing the comparability of uncontrolled transaction with an international transaction should be the data relating to the financial year in which international transactions have been entered into. However, the rule also provides exception and permits use of data for the preceding two years if and only if, it is proved that such data reveals a fact which could have an influence on the determination of arm's length price. Therefore, the exception comes into the play only when a proof that earlier year data could have an influence on determination of arm's length price is brought on the record.

10.3.3.4. Rationale: The mandatory requirement under the law to use contemporaneous document has a solid economic sense in the way that contemporaneous transaction reflect similar economic condition. Therefore, use of current year data is more relevant and appropriate for ensuring a higher degree of comparability of uncontrolled transaction for arriving at arm's length price in respect of international transaction. In India, contemporaneous data which may be available to the taxpayer and tax administration at the time of filing of the tax return or conducting ex post facto analysis of transfer pricing studies cannot be held as use of hindsight.

**10.3.4 Issue relating to risks:**

10.3.4.1. A comparison of functions performed, assets employed and risks assumed is basic to any comparability analysis. India believes that the risk of a MNE is a by-product of performance of functions and ownership, exploitation or use of assets employed over a period of time. Accordingly, risk is not an independent element but is similar in nature to functions and assets. In this context, India believes that it is unfair to give undue importance to risk in determination of arm's length price in comparison to functions performed and assets employed.

10.3.4.2. Identification of risk and the party who bears such risks are important steps in comparability analysis. India believes that the conduct of the parties is key to determine whether the actual allocation of risk conforms to contractual risk allocation. Allocation of risk depends upon ability of parties to transaction to exercise control over risk. Core functions, key responsibilities, key decision making and level of individual responsibility for the key decisions are important factors to identity party which has control over the risks.

10.3.4.3. In India, MNEs are making claims before the transfer pricing auditor that related parties engaged in contract R&D or other contract services in India are risk free entities. Accordingly, these related parties are entitled to only routine (low) cost plus remuneration. MNEs also contend that the risks of R&D activities or services are being controlled by them and Indian entities being risk free entities are entitled to (low) cost plus remuneration.

10.3.4.3. The Indian transfer pricing administration does not agree with the notion that risk can be controlled remotely by the parent company and that the Indian subsidiaries or related party engaged in core functions, such as carrying out research and development activities or providing services are risk free entities. India believes that core function of R&D or services are located in India which in turn require important strategic decisions by management and employees of Indian subsidiaries or related party to design, direction of R&D activities or providing services and monitoring of R&D activities etc. Accordingly, the Indian subsidiary exercises control over the operational and other risks. In these circumstances, the ability of the parent company to exercise control over the risk - remotely and from a place where core functions of R&D and services are not located - is very limited. In these circumstances, allocation of risk to the parent MNE is not only questionable but is devoid of logical conclusion.

10.3.4.4. India believes that, in the circumstances mentioned at 10.3.4.3., the subsidiary carries out core functions and by taking strategic operational decisions controls a substantial part of risk. India believes that the parent company should be entitled to appropriate returns for provision of funds and overall direction to R&D activity or services. The Indian subsidiary should also similarly be entitled to returns on their core function including strategic decisions and control on risk related to operation of R&D activities. In this context, Indian tax administration is of the view that allocation of routine cost plus return in these cases will not reflect a true arm's length price of the transaction.

**10.3.5. Arm's length range**

Application of most appropriate method may set up comparable data which may result in computation of more than one arm's length price. Where there may be more than one arm's length price, mean of such prices is considered. Indian transfer pricing regulations provide that in such a case the arithmetic mean of the prices should be adopted as arm's length price. If the variation between the arithmetic mean of uncontrolled prices and price of international transaction does not exceed 3% or notified percentage of such transfer pricing, then transfer price will be considered to be at arm's length. In case transfer price crosses the tolerance limit, the adjustment is made from the central point determined on the basis of arithmetic mean. Indian transfer pricing regulation do not mandate use of inter quartile range.

**10.3.6. Comparability adjustment**

10.3.6.1. Like many other countries, Indian transfer pricing regulations provide for "reasonably accurate comparability adjustments". The onus to prove "reasonably accurate comparability adjustment" is on the taxpayer. The experience of Indian transfer pricing administration indicates that it is possible to address the issue of accounting difference and difference in capacity utilization and intensities of working capital by making comparability adjustments. However, Indian transfer pricing administration finds it extremely difficult to make risk adjustments in absence of any reliable and robust and internationally agreed methodology to provide risk adjustment. In some cases taxpayers have used Capital Asset Pricing Method (CAPM). However, the methodology was found flawed for the reasons outlined in the following paragraphs.

10.3.6.2. The CAPM model assumes that most assets rate of return within a portfolio are normally distributed (meaning rates of return do not deviate too much from the mean). However, historically speaking, equities have been prone to large deviations from the mean much more frequently than it is generally assumed under the CAPM model. So, if an asset is actually prone to large swings in either direction from its mean, then it stands to reason that its risk aspect may not be correctly captured by the CAPM calculation.

10.3.6.3. Capital asset pricing model is not able to capture all variations in equity returns in same industry segment. Past empirical studies have demonstrated that some stocks, although they had lower beta and implied lower risk vs. return ratio, still managed to pull off higher returns than the CAPM model would have assumed initially.

10.3.6.4. On a more practical level, one of the shortfalls of CAPM is that the model assumes all investors have the same ideas of what constitutes risk and required rates of return, as well as the fact that the model excludes the impact of taxes and transaction costs which, in reality, have adverse impact on the expected rate of return.

10.3.6.5. The CAPM assumes the application of the market portfolio, which is supposed to consist of all risky assets in all markets. The CAPM also assumes that investors have no individual preference as to which risky assets they wish to invest in and in which markets. Yet, investors have been known to depart from assets 'risk vs. return profiles often and particularly at times when markets were not normally distributed.

10.3.6.6. The CAPM accepts the concepts of the market portfolio, which theorizes inclusion of literally all asset classes, including real estate, art intellectual property etc. However, in reality such a market portfolio is impossible to construct which is why it is often equated with various composites. However, limiting the market portfolio in such a manner could and it indeed has created fallacies within the CAPM model, thus rendering it at the very least empirically inconsistent.

10.3.6.7. An important flaw relating to the computation of risk adjustment by the taxpayer is use of the "Beta" concept. It is important to remember that computation of beta is based on a presumption that high-beta shares usually give the highest returns. Over a long period of time, however, high beta shares are the worst performers during market declines (bear market) which are more common phenomena in Indian stock exchange. While someone might receive high returns from high beta shares, there is no guarantee that the CAPM return is realized. It is worthwhile to mention here that the computation of beta in this case is based on seven year average price of comparables and tested party shares; the methodology of taking an average of such a long period is highly questionable in existing volatile world market conditions.

10.3.6.8. The Indian tax administration has also experienced difficulties in getting reliable data for computation of comparability adjustments like capacity and working capital adjustments, where methodology to provide comparability adjustment is more or less internationally agreed.

**10.3.7 Location Savings**

10.3.7.1. It is view of the Indian transfer pricing administration that the concept of "location savings" - which refer to cost savings in a low cost jurisdiction like India – should be one of the major aspects to be considered while carrying out comparability analysis during transfer pricing audits. Location savings has a much broader meaning; it goes beyond the issue of relocating a business from a 'high cost' location to a 'low cost' location and relates to any cost advantage. MNEs continuously search options to lower their costs in order to increase profits. India provides operational advantages to the

MNEs such as labour or skill employee cost, raw material cost, transaction costs, rent, training cost, infrastructure cost, tax incentive etc.

10.3.7.2. It has also been noticed that India also provides following Location Specific Advantages (LSAs) to MNE in addition to location savings:

- Highly specialized skilled manpower and knowledge
- Access and proximity to growing local/regional market
- Large customer base with increased spending capacity
- Superior information network
- Superior distribution network
- Incentives
- Market premium

10.3.7.3. The incremental profit from LSAs is known as “location rents”. The main issue in transfer pricing is the quantification and allocation of location savings and location rents among the associated enterprises. Under arm’s length pricing, allocation of location savings and rents between associated enterprises should be made by reference to what independent parties would have agreed in comparable circumstances. The Indian transfer pricing administration believes it is possible to use the profit split method to determine arm’s length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available. In these circumstances, it is considered that the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), **and** the bargaining power of the parties (which at arm’s length would be determined by the competitiveness of the market - availability of substitutes, cost structure etc) should both be considered appropriate factors.

10.3.7.4. Comparability analysis and benchmarking by taking local comparables will determine the price of a transaction with a related party in a low cost jurisdiction. However, it will not take into account the benefit of location savings which can be computed by taking into account cost difference between cost of low cost country and high cost country from where the business activity was relocated. In view of this, the price determined on the basis of local comparables is not consistent with arm’s length price because any arm’s length transaction between two unrelated parties would not be possible without benefiting both parties to the transaction.

10.3.7.5. Hypothetically, if an unrelated third party had to compensate another party to the transaction in a low cost jurisdiction that was equal to the cost savings and location rents attributable to the location, there would be no incentive for the unrelated third party to relocate business to a low cost jurisdiction. Thus, arm’s length compensation for cost savings and location rents should be such that both parties would benefit from participating in the transaction. In other words, it should be not less than zero and not greater than the value of cost savings and locations rents; it should also reflect an appropriate split of the cost savings and location rents between the parties.

**10.3.8. Intangibles**

**General**

10.3.8.1. Transfer pricing of intangibles is well known as a difficult area of taxation practice. However, the pace of growth of the intangible economy has opened new challenges to the arm's length principle. Seventy five percent of all private R&D expenditure worldwide is accounted for by MNEs. World royalty and license fee receipts that were just US $ 29 billion in the year 1990 has gone up to US $ 191 billion in 2010.

10.3.8.2. The transactions involving intangible assets are difficult to evaluate because of the following reasons:

- Intangibles are seldom traded in the external market and it is very difficult to find comparables in the public domain.
- Intangibles are often transferred bundled along with tangible assets.
- They are difficult to be detected.

10.3.8.3. A number of difficulties arise while dealing with intangibles. Some of the key issues revolve around determination of arm's length price of rate of royalties, allocation of cost of development of market and brand in a new country, remuneration for development of marketing, Research and Development intangibles and their use, transfer pricing of co-branding etc. Some of the Indian experiences in this regard are discussed below.

10.3.8.4. With regard to payment of royalties, MNEs often enter into agreements allowing use of brands, trademarks, know how, design, technology etc. by their subsidiaries or related parties in India. Such payments can be in a lump sum, periodical payments or a combination of both types of payments. It is an internationally agreed position that intellectual property which is owned by one entity and used by another entity generally requires royalty payment. However, the important issue in this regard is determination of the rate of royalty. The main challenge in determination of arm's length price of royalty rate is to find comparables in the public domain with sufficient information required for comparability analysis. The Indian experience suggests that it is impossible to find comparable arm's length prices in most cases. The use of profit split method as an alternative is generally not a feasible option due to lack of requisite information.

10.3.8.5. The Indian tax administration has noticed serious difficulties in determining the rate of royalty charged for use of brand and trademark in certain cases. In some cases the user had borne significant costs on promotion of the brand/trademark, and to promote and develop customer loyalty for brand/trademark in a new market. In these cases, royalty rate charged by the MNE will depend upon the cost borne by the subsidiary or related party to promote the brand and trademark and to develop customer loyalty for brand and product. In many cases no royalty may be charged under uncontrolled environment and the subsidiary would require arm's length compensation for economic ownership of marketing intangible developed by it and for enhancing the value of brand and trademark owned by parent MNEs in the new emerging market like India.

10.3.8.6. In many cases, Indian subsidiaries which use technical know-how of their parent company have incurred significant expenditure to customize such know-how and to enhance its value by their R&D efforts. Costs on activities, such as R&D activities which have contributed in enhancing the value of know-how owned by parent company is generally considered by Indian transfer pricing officer while determining arm's length price of royalty for use of technical know-how.

10.3.8.7. The Indian transfer pricing administration has also noted significant transfer pricing issues in cases of co-branding of new foreign brand of parent MNE (which is unknown to new market like India) with popular Indian brand name. Since the Indian subsidiary has developed valuable Indian brand in the domestic market over a period of time, incurring huge expenditure on advertisement, marketing and sales promotion, it should be entitled for arm's length remuneration for contributing to the value of foreign little known brand through market recognition by co-branding it with a popular Indian brand.

**R&D activities**

10.3.8.8. Several global MNEs have established subsidiaries in India for research and development activities on contract basis to take advantage of the large pool of skilled manpower which are available at a lower cost. These Indian subsidiaries are generally compensated on the basis of routine and low cost plus mark up. The parent MNE of these R&D centres justify low cost plus markup on the ground that they control all the risk and their subsidiaries or related parties are risk free or limited risk bearing entities. The claim of parent MNEs that they control the risk and are entitled for major part of profit from R&D activities is based on following contentions:

- Parent MNE designs and monitors all the research programmes of the subsidiary.
- Parent MNE provides fund needed for R&D activities.
- Parent MNE controls the annual budget of the subsidiary for R&D activities.
- Parent MNE controls and takes all the strategic decisions with regards to core functions of R&D activities of the subsidiary.
- Parent MNE bears the risk of unsuccessful R&D activities.

10.3.8.9. The Indian transfer pricing administration always undertakes a detailed enquiry in cases of contract R&D centres. Such an enquiry seeks to ascertain correctness of the functional profile of subsidiary and parent MNE on the basis of transfer pricing report filed by the taxpayers, as well as information available in the public domain and commercial databases. After conducting detailed enquiries, the Indian tax administration often reaches the following conclusions:

- Most parent MNEs were not able to file relevant documents to justify their claim of controlling risk of core functions of R&D activities and asset (including intangible assets) which are located in the country of subsidiary or related party.
- Contrary to the above, it was found that day to day strategic decisions and monitoring of R&D activities were carried out by personnel of subsidiary who were engaged in actual R&D activities and bore relevant operational risks.
- The management of Indian subsidiary also took decision of allocation of budget to different streams of R&D activities and Indian management also monitored day to day performance of R&D activities.
- It was true that in most of the cases funds for R&D activities were transferred from the MNE parent and they bore the risk of such fund. However, in addition to "capital" other important assets like technically skilled manpower, know how for R&D activities etc were developed and owned by the Indian subsidiary. Accordingly, control of risk of the asset lies both with the MNE parent and Indian subsidiary but the Indian subsidiary controls more risks as compared to the MNE parent.

10.3.8.10. On the basis of above functional analysis, the Indian transfer pricing administration decided in most of the cases that Indian subsidiaries were not risk free entities but bore significant risk. Accordingly Indian subsidiaries were entitled to an appropriate return for their function including the strategic decision, monitoring, use of their assets and control over the risk. In view of these facts, routine cost plus compensation model was not held at arm's length price.

10.3.8.11. Most of these R&D centres in India were actually found to be engaged in creation of unique intangibles, legal ownership of which was transferred to their parent MNEs under agreement. Such transfer took place without any appropriate compensation and patents for these intangibles were registered in the name of parent MNE. In these cases the Indian transfer pricing administration allocated additional arm's length compensation for transfer of such intangibles in addition to arm's length compensation for R&D activities.

**Marketing Intangibles**

10.3.8.12. Transfer pricing aspect of marketing intangibles has been a focus area for the Indian transfer pricing administration. The issue is particularly relevant to India due to its unique market specific characteristics such as location advantages, market accessibility, large customer base, market premium, spending power of Indian customers etc. The Indian market has witnessed substantial marketing activities by the subsidiary/related party of the MNE groups in recent past, that have resulted in creation of local marketing intangibles.

10.3.8.11. For Indian transfer pricing administration first important step is to identify marketing intangibles. The marketing intangibles are generally identified on the basis of the efforts of Indian subsidiary/related party on:

- Enhancing the value of foreign trade mark/brand unknown to Indian market by incurring huge advertisement, marketing and sale promotion expenditure.
- Creation of brand and product loyalty in the minds of customers.
- Creation of efficient supply chain.
- Establishing distributor network in the country.
- After sale services support network in the country.
- Conducting customer and market researches.
- Establishing customer list etc.

10.3.8.12. Since Indian subsidiaries/related parties (which are claimed as no risk and limited risk bearing distributors by parent MNE in order to justify low cost plus return) have incurred and borne huge expenditure on development of marketing intangibles. These entities generally incur huge losses or disclose very nominal profit as evident from their return of income. Determination of ALP in cases of marketing intangibles generally involves following steps:

- Functional analysis of profile of the Indian and parent MNE to ascertain whether the Indian taxpayer is a risk free, limited risk bearing or risk bearing entity?
- Identification of nature, types and stages of development of marketing intangibles. The Indian entity may be engaged in different stages of development of marketing intangibles. For example

if an MNEs is new entrant in Indian market, the related party in India will incur substantial expenditure:

- to create awareness about trade mark, brand and product or services of MNE group in India.
- customer loyalty for brand and products/services.
- dealer network.
- after sale services network.
- market and customer research
- creation of customer list.

10.3.8.13. After some years of operation, the cost on developing and sustaining marketing intangible may be reduced.

- Identification of expenditure on launch of new products in India and to ascertain who had borne such expenditure.
- to ascertain who had borne the cost of development of marketing intangibles.
- examination of remuneration model to Indian related party.

10.3.8.14. The Indian tax administration computes the ALP in the cases involving marketing intangibles following the concept of bright line i.e., no risk or limited risk distributor will bear the cost of only routine expenditure on advertisement, marketing and sale promotion. However, the tax administration faces following challenges in determination of the ALP:

- Whether parent MNE should reimburse the cost incurred by the Indian related party on development of marketing intangibles with or without mark-up.

- Lack of uniform accounting codes creates a significant challenge in identification of advertisement, marketing and sales promotion (AMP) expenditure in comparable companies and tested party.

- The developer of marketing intangibles who has economic ownership in the intangibles is entitled to additional returns. However, the difficult question is what should be the arm's length price of such returns.

10.3.8.15. The important issue in the determination of ALP in these cases is to examine who benefits from the extraordinary AMP expenditure. Taxpayers generally claim that such extraordinary expenditure helps the business of the Indian entity also in addition to parent MNE. However, the tax authorities in India have found that Indian distributors are claimed to be no risk or low risk bearing entities and are getting fixed and routine return on cost plus basis. They do not get a share in the excess profit relatable to local marketing intangibles. Accordingly, extra-ordinary AMP expenditure does not enhance the profitability of Indian subsidiary or related party. This conclusion of the tax authorities is further supported by the fact that these so called risk-free or limited risk distributors have disclosed huge losses even when they are entitled for fixed return on cost plus basis and should not have incurred losses.

10.3.8.16. In this context, the Transfer Pricing administration have taken a view that such Indian entities which incur excessive AMP expenses, bear risks and perform functions beyond what an independent distributor with similar profile would incur or perform for the benefit of its own distribution activities should be compensated for return on intangibles. Such compensation would be in the form of reimbursement of the excess AMP expenditure along with mark-up. Alternatively, the Indian entity should be allowed to share profit related to marketing intangibles. If no reimbursement is made in these type of cases along with mark-up, or the related party does not get an arm's length return for development of marketing intangibles in the form of its entitlement to share profits, the Indian tax administration makes adjustment on account of reimbursement of excess AMP expenditure along with a mark-up for the functions undertaken by the subsidiary/related party.

**10.3.9. Intragroup Services**

10.3.9.1. Globalization and the drive to achieve efficiencies within MNE groups have encouraged sharing of resources to provides support between one or more location by way of shared services. Since these intra group services are the main component of "tax efficient supply chain management" within an MNE group, the Indian transfer pricing authorities attach high priority to this aspect of transfer pricing. The tax administration has noticed that some of the services are relatively straight forward in nature like marketing, advertisement, trading, management consulting etc. However, other services may be more complex and can often be provided on stand-alone basis or to be provided as part of the package and is linked one way or another to supply of goods or intangible assets. An example can be agency sale technical support which obligates the licensor to assist the licensee in setting up of manufacturing facilities, including training of staff.

10.3.9.2. The Indian transfer pricing administration generally considers following questions in order to identify intra group services requiring arm's length remuneration:

- Whether Indian subsidiaries have received any related party services i.e., intra group services?
- Nature and detail of services including quantum of services received by the related party.
- Whether services have been provided in order to meet specific need of recipient of the services?
- What are the economic and commercial benefits derived by the recipient of intra group services?
- Whether in comparable circumstances an independent enterprise would be willing to pay the price for such services?
- Whether an independent third party would be willing and able to provide such services?

10.3.9.2. The answers to above questions enable the Indian tax administration to determine if the Indian subsidiary has received or provided intra group services which requires arms' length remuneration. Determination of the arm's length price of intra-group services normally involve following steps:

- Identification of the cost incurred by the group entity in providing intra group services to the related party.
- Understanding the basis for allocation of cost to various related parties i.e., nature of allocation keys.
- Whether intra group services will require reimbursement of expenditure along with markup.
- Identification of arm's length price of markup for rendering of services.

10.3.9.3. Identification of the services which require an arm's length remuneration is one of the main challenges before the Indian transfer pricing administration. India believes that shareholder services, duplicate services and incidental benefit from group services do not give rise to intra group services requiring arm's length remuneration. However, such conclusion would need a great deal of analysis. The biggest challenge in determination of the arm's length price is allocation of cost by using allocation keys. The nature of allocation keys generally varies with the nature of services. However, it is difficult to reach agreement between the tax administration and taxpayer on the nature of allocation of keys.

10.3.9.4. The next challenge before the transfer pricing administration is a most commonly asked question whether or not it is necessary for services provider to make a profit. Typical example of this would include treatment of pass through cost. Another important question is how to determine a percentage of mark up and to fix the benchmark of markup are tedious processes. The fixing up of the cost base to compute the markup is another complex issue and it is a difficult decision to include or not to include various types of overhead.

10.3.9.5. A brief review of cases where adjustments have been made by Indian transfer pricing administration has revealed that most of MNE parents do not allow any profit markup on the services rendered by Indian subsidiaries to them. However, in some exceptional cases a low markup of 5% to 10% is allowed on some services with a restricted cost base. On the other hand, where Indian subsidiaries or related parties receive intra group services, parent MNEs generally charge mark up on all the services provided to such entities, including duplicate services, shareholding services and services which provide only incidental benefits to the Indian entities. The rate of markup charged on such intra-group services is also mostly on the higher side. The Indian transfer pricing administration has also noticed that in several cases, the claim of rendering services was found to be incorrect or the services were found not to be intra-group services which required arm's length remuneration.

10.3.9.6. In view of the above facts, transfer pricing of intra-group services is a high risk area for the Indian transfer pricing administration.

**10.3.10. Financial Transactions**

10.3.10.1. Intercompany loans and guarantees are becoming common international transactions between related parties due to management of cross border funding within group entities of a MNE group. Transfer pricing of inter-company loans and guarantees are increasingly being considered some of the most complex transfer pricing issues in India. The Indian transfer pricing administration has followed a quite sophisticated methodology for pricing inter-company loans which revolves around:

- comparison of terms and conditions of loan agreement.
- determination of credit rating of lender and borrower.
- Identification of comparables third party loan agreement.
- suitable adjustments to enhance comparability.

10.3.10.2. The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent has advanced to its associated entities (AE) in a foreign jurisdiction either interest free loans or loans at LIBOR/EURIBOR rates . The main issue before the transfer pricing administration is benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans. The Indian transfer pricing administration has determined that since the loans are advanced from India and Indian currency has been subsequently converted into the currency of the geographic location of the AE, the Prime Lending Rate (PLR) of the Indian banks should be applied as the external CUP and not the LIBOR or EURIBOR rate.

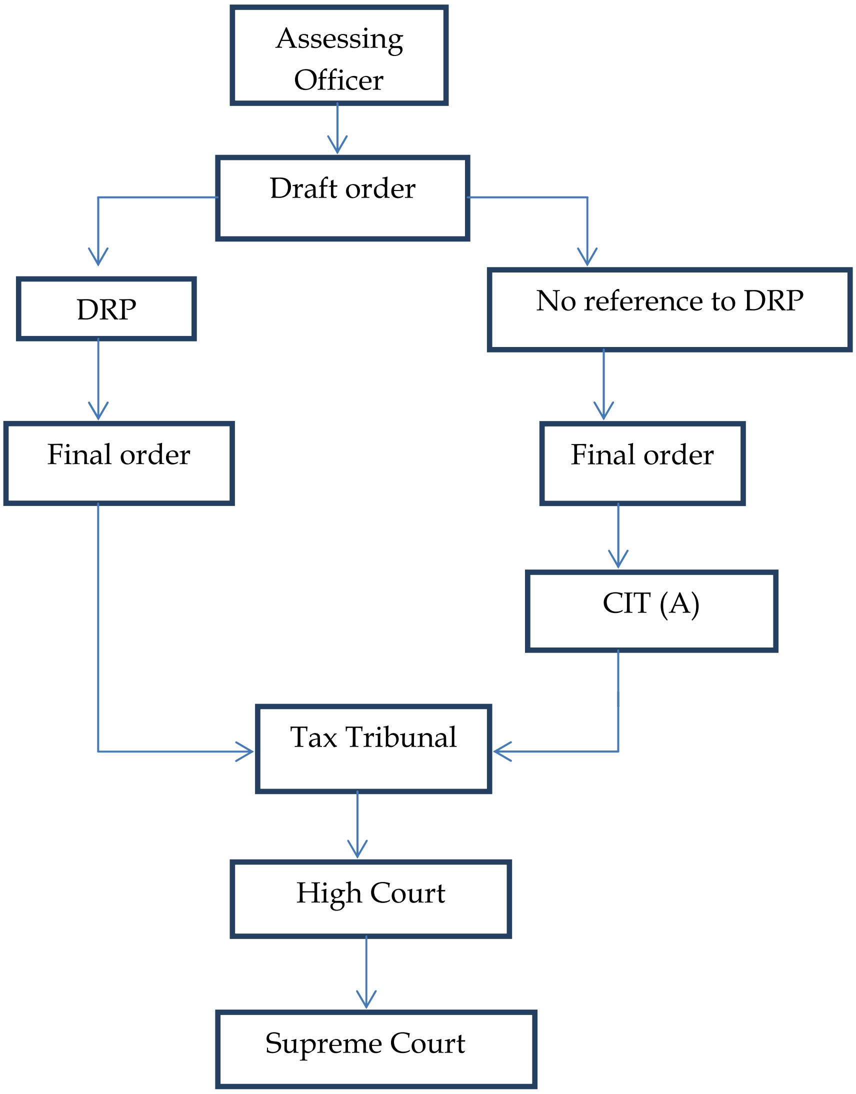
10.3.10.3. A further issue in financial transactions is credit guarantee fees. With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to its associated entities (AEs) abroad, where the Indian parent as guarantor agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an AE of the Indian MNE to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantee under the comparable uncontrolled price method. In most cases, interest rates quotes and guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in the credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of Indian bond is also considered for determination of the arm’s length price of such guarantees.

10.3.10.4. However, the Indian transfer pricing administration is facing a challenge due to non-availability of specialized database and transfer price of complex cases of inter-company loans in cases of mergers and acquisitions which involve complex inter-company loan instruments as well as implicit element of guarantee from parent company in securing debt.

**10.3.11. Dispute Resolution Process**

10.3.11.1. A comprehensive dispute resolution mechanism is available to the taxpayers in India that face transfer pricing adjustments. As a part of the legal process in all cases, the Assessing Officer (AO) incorporates the order of the Transfer Pricing Officer (TPO) in his order and issues a draft order to the taxpayer. The taxpayer has the option to file an objection against the draft order before the DRP which is a panel comprising three Commissioners of Income Tax. For cases referred to the DRP, the AO issues a final order in compliance with the directions of DRP. In cases where the taxpayer chooses not to file an objection before the DRP, the draft order by the Assessing Officer incorporating the order of TPO becomes final and the taxpayer may file an appeal before the Commissioner of Income Tax (Appeals).

10.3.11.2. The sequence and availability of dispute resolution forums to the taxpayer in India can be depicted as follows:




10.3.11.3. Transfer pricing administration is more than a decade old in India. However disputes are increasing with each transfer pricing audit cycle, due to the following factors:

- Cross border transactions have increased exponentially in the last one decade.
- Lack of international consensus on taxation of certain group cross border transactions like intangible, financial transactions, intra-group services etc.
- Difficulty in applying the arm's length principle to complex transactions like business restructuring.
- Taxpayers in India can postpone payment of tax liability by resorting to litigation.
- Availability of multiple channels to resolve disputes in India.

10.3.11.4. The Indian tax administration is aware of the problem of increasing disputes and has taken several steps to reduce litigation and the time needed to resolve tax disputes. The steps taken by the Indian tax administration are:

- International transactions below INR 150,000,000 (US$ 3 Million) are not selected for transfer pricing audit.
- No adjustments are made in cases where the variation between the arm's length prices determined and the price of the international transaction does not exceed 3% or other percentage notified.
- Significant efforts have been made to provide certainty in application of transfer pricing laws.
- There is a time limit for disposal of objection of taxpayer before the DRP.
- Indicative time limits have been provided for various judicial forums.
- Direct appeal to the tax tribunal is provided against transfer pricing orders approved by the DRP.
- Dedicated and specialized appellate Commissioners and benches of tax tribunals have been put in place to deal with disputes on transfer pricing.
- The process for Mutual Agreement Procedures has been put on fast track.

10.3.11.5. India has also enacted legislative provisions for entering into Advance Pricing Agreements; the scheme is effective from 30 August 2012. An APA is an agreement between the Central Board of Direct Taxes and any person, which determines, in advance, the arm's length price or specifies the manner of the determination of arm's length price (or both), in relation to an international transaction. Once an APA has been entered into, the arm's length price of the international transaction will be determined in accordance with the terms of the APA for the period specified therein. The APA process is voluntary and will supplement appeal and other treaty mechanisms for resolving transfer pricing disputes. The APA term can be a maximum of five years; there are three types of APA - unilateral, bilateral and multilateral - and the applicant may to choose a particular type when making the application. The scheme provides for a pre-filing consultation between the taxpayer and the APA team before formal application; such consultation can also be on an anonymous basis. The formal APA application must be filed after the pre-filing consultation with specified fees.

10.3.11.6. India believes that tax disputes in the field of transfer pricing require concentrated efforts by all trading partner countries. The ability of a country to reduce the disputes by taking unilateral legislative and administrative actions is very limited at the time when cross border transactions amongst the related parties have increased substantially in the last decade. India appreciates efforts made by the UN Committee of Tax Experts to provide guidance on application of transfer pricing law.