

Recent Trends in Indian Transfer Pricing Audits



Introduction

Since their advent in 2001-02, the transfer pricing regulations in India have come of age— both in terms of quality of audits, as well as the revenue generated for the Indian Government. While there aren't too many changes in the regulations *per se* since their inception, the approach of Indian tax authorities have definitely helped the Indian Government mop up around INR 23,000 crores (approx. US\$ 5,000 millions) in revenue over the past 5 years.

All this is a result of a distinct focus on the part of Indian tax authorities to train the field officers handling transfer pricing cases, creating a special cell of revenue officers to scrutinize transfer pricing cases, increasing resources both in terms of man-power and time limit for finalizing audits. Coupled with the above factors, the Indian tax authorities have the infamous distinction of being unduly revenue biased.

In fact, in the recently completed round of transfer pricing assessment which related to FY 05-06, there have been adjustments in almost 60% cases that were selected for detailed scrutiny. This percentage is a sharp increase over average of approx 25% for the earlier 4 years. Further, what is more striking to

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note is that the total addition on this account amounts to almost INR 10,000 Crores; which is only slightly lower than the total demand raised collectively during audits in the past 4 years. However, unlike in the past, when the transfer pricing officer's order was binding, the tax demand from this year will be finalised only if the newly set-up Dispute Resolution Panel confirms the same.

Critical issues

Some of the critical issues that the taxpayers faced during the transfer pricing audits are:

- In case of software/ITES companies, the tax authorities denied adjustments on account of risk differentials, differences on account of working capital etc. In fact, the search process adopted by taxpayers has also been rejected in a majority of cases, and margins of around 21% on costs (for software companies) and 24% on costs (for

SKP Group

Contact
 Sapan Parekh
 CEO, SKP Group
 sapan.parekh@skpgroup.com

 www.skpgroup.com

Head Office
 2nd Floor, Ballard House,
 Adi Marzban Path , Ballard Estate
 Mumbai - 400 001, India
 Tel: + 91 22 6617 8000
 Fax: +91 22 6617 8002

Other offices located at Bangalore, Delhi, Hyderabad and Pune.

ITES companies) have been used as benchmarks.

- Similarly, a benchmark of around 35-40% on costs was used for investment advisory services and correspondent banking services.
- Payments of royalties, management fees, secondment cross-charges etc. have been disallowed completely in cases where the existence as well as the adequacy of the “benefit test” has not been adequately documented as well as demonstrated before the tax authorities.
- Notional Guarantee Fees have been added/charged in cases where guarantees/letters of comfort etc. are being issued by Indian entities to lenders of overseas subsidiaries/group companies.
- Notional charge has been added for creating “marketing intangible” for overseas parent/group company in respect of marketing services rendered by Indian marketing/distribution arm.
- Notional interest has been charged in cases of delayed receipts on account of trade transactions from group companies and in cases of interest free loans granted to group companies.

Devil in Documentation!

While it is difficult to generalize the approach of the tax authorities, going by the orders passed this year, one can say that these adjustments were mainly due to the fact that the documentation was either incomplete or was not properly presented before the authorities. Although the current regulations do provide for comprehensive documentation rules, these rules are given a go-bye in practice in many cases. Certain element of revenue biased approach also cannot be ruled out.

On the other hand, there were also orders passed in favour of the taxpayer in cases where the genuineness of intra-group pricing of transactions was well demonstrated to the tax/transfer pricing authorities. The documentation maintained and submitted to the authorities was, on many occasions, over and above the minimum documentation required under the regulations.

For instance, in the case of an ITES entity, which had incurred losses during the year, the arm’s length nature of pricing policy was justified and accepted based on host of business/commercial reasons such as huge capacity expansion, idle capacity during the year under consideration, etc.

Similarly, in the case of justifying management fee and royalty charge, a plethora of documentation in the nature of notes, memos, e-mail exchanges, reports, processes documents etc. was provided to the tax / transfer pricing authorities to demonstrate the satisfaction of the “benefit test”; as well as the arm’s length nature of payments. Consequently, against the general practice adopted by the authorities, there was no adjustment on account of management fees as well as royalties in the instant case.

Way forward

If the commercial reasoning behind the arm’s length nature of intra-group transactions is adequately documented as well as explained to the tax/transfer pricing authorities, the taxpayer has a very good chance of sailing through the transfer pricing audit/scrutiny without any adverse adjustments.

A good transfer pricing documentation is one which is maintained on an “as and when” basis. In other words, the documentation must be maintained at the very moment when the transaction takes place.

It is also imperative that the quality and adequacy of documentation must be subjected to an internal review by an “in-house” team or preferably, external consultants at regular quarterly/half yearly intervals; in addition to the final review and sign-off at the year end. This would enable taxpayers to capture the thought process and the business realities when the same is still fresh in the memory; rather than digging for such information at a later date.

Further, many taxpayers have the practice of maintaining documentation only if the case is selected for a transfer pricing scrutiny. This approach is fraught with huge risks. Even the regulations require the documentation to be contemporaneous. As the good old saying goes, “A stitch in time saves nine!”

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For further information and assistance you may email sapan.parekh@skpgroup.com