Research Paper Taxation Law

The concept of Transfer Pricing and Advance Pricing Agreement in India

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ABSTRACT

India being a developing country and one of the biggest economies, has seen an increasing participation of multinational group in economic activities which has resulted in a substantial increase in issues related to transactions entered between two or more enterprises belonging to the same group. This is when the need for transfer pricing regulations emerged in India. Basically transfer pricing is the amount charged by a company when it transfers the goods to other company which may be a multinational company. On the other hand, Indian Advance Pricing Agreement (APA) might not be the most attractive APA regime in terms of the heavy fees the multinationals need to pay at the time of filing application considering the fact that country like Japan and Australia do not charge any filing fees that too being the first countries to implement them.

Keywords : Transfer Pricing, Advance Pricing Agreement, Income Tax, India

Introduction

In the beginning of the twentieth century, indirect taxes on trade, consumption, etc. were the most important type of taxes. The trend since then has been an increasing importance for the income taxation. Most taxes are levied and constructed only to pursue fiscal goals. However, at least officially it is considered that the income tax to a certain extent should be used to redistribute income. The concept of taxation even in India is not new. The wise sage Manu Smriti advised that taxes should be related to the income and expenditure of the subject matter. This tool of planned management was evidently used during the Mauryan Empire. Kautilya's Arthshastra has clear depiction of taxation in which taxes were collected on forest produce as well as from mining of metals. Salt tax was also a very significant source of revenue. After the advent of the East India Company, Sir James Wilson introduced tax in order to cope up with the losses caused by the rebellion of 1857. The Income Tax Act of 1961 was the first tax provision to be passed in free India. Since then several amendments have been there in the original act, the latest being the amendment of 2013 regarding the filing for income tax returns.

The concept of Transfer Pricing

The concept of tax revolves around the concept of transfer pricing which tends to be the method for analysing, documenting and adjusting the charges between two legal entities which ultimately leads to the determination of a corporation's net profit or net loss before the taxing authorities. This concept of comprehensive transfer pricing was first adopted by the US in the year 1968. The Organisation for Economic Corporation and Development prepared reports on transfer pricing in the year 1979 and 1984 but issued the final draft containing the modern transfer pricing guidelines in 1995. The concept of transfer pricing was introduced due to the advent of globalization. The whole idea of developing a conscious that world is one village gave the need to evolve transfer pricing. Transfer pricing deals with the issue of price charging between associated enterprises established in different tax jurisdictions for their intercompany transactions. In other words, tax optimisation is possible through transfer pricing.

Transfer pricing in India was given a shape by a report submitted by committee under the chairmanship of Mr. Raj Narayan. The Income Tax Act of 1961 in India did not address Transfer pricing per se but the government disallowed "excessive payments" that one party makes to a related party. India formerly adopted Organisation for Economic Co-operation and Development (OECD) transfer pricing concept in the year 2000. Now the transfer pricing regime of India limits to international businesses and exempts wholly domestic Indian business. These businesses are within the purview of the transfer pricing provisions:

1. Either of the two parties to a transaction where one or both parties or non resident
2. The transfer pricing do not apply to all domestic transactions
3. The transfer pricing provisions do not apply between two residents of India

A very import case pertaining to transfer pricing was the Vodafone acquisition of Hutchison Essar. Vodafone acquired Hutchison Essar which was the fourth largest mobile phone operator in India by paying $ 10.9 billion in May, 2007. The tax authorities in India sought $ 2.1 billion from Vodafone as a result of Vodafone making that purchase of Hutchison Essar shares. The taxpayers expressed two alternative theories to confront the Indian tax authorities. Firstly, Vodafone argued that Hutchison Telecommunications International of Hong Kong was the seller of the mobile phone business and that Hutchison Telecommunications International, as the seller, must pay the tax if India prevailed in determining tax liability. Secondly, Vodafone argued that no tax is payable by anyone because the transaction took placing offshore. Hutchison Whampoa which is the parent company is based in Hong Kong. Hutchison held its controlling stake in Hutchison Essar through a Mauritius company. The tax authorities in India asserted that the Vodafone-Hutchison transaction is subject to capital gains taxation in India because the assets were in India. The capital gain was $9.6 billion, levied at the 22% rate amounting to $ 2.1 billion. The tax authorities in India argued that Vodafone should have withheld the $ 2.1 billion and paid the $ 2.1 billion to India. The Indian Supreme Court held in favour of Vodafone on January 20, 2012.

One of the steps that the Indian finance ministry has initiated to reduce transfer pricing disputes, is the proposal of the Safe Harbour Policy with some new rules to govern the transfer pricing regulations. Following a record increase in the countries tax and audit disputes the draft aims at codifying the countries transfer pricing scheme. The Rangacharya Com-

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mittee, a four person panel of government representatives recommended the new rules which were used in the draft. Businesses in India will benefit due to the reduction in complicated compliance procedures whereas the tax authorities will be able to look into transfer pricing disputes using lesser resources.

It will be possible because associated entities working in different tax jurisdictions will submit their transfer prices directly to the income tax authorities thus reducing the length of procedure and the scope of litigation.

Advance Pricing Agreement (APA) in India and United States of America

The provisions for the APA programme as introduced by the Finance Act, 2012 are mentioned in section 92CC and 92CD of the Income Tax Act. These sections read with Rules 10F to 10T and 44GA (added after the 10th amendment in Income Tax Rules 2012) provide the Advance Pricing Agreement Regime in the Indian transfer pricing environment. Advance pricing agreement is basically an agreement between a taxpayer and a taxing authority for prospective transactions. Advance pricing was introduced in India with the aim that it will reduce transfer pricing disputes. The eligibility criteria for filing an application is that any 'person' undertaking an international transaction or planning to undertake any such transaction can file an application for APA as mentioned in section 92CC (1) of the act read with rule 10G of the rules. The term for APAs in India ranges from a minimum period of three years and up to a maximum period of five years. The Indian APA scheme follows a five stage process which once concluded brings the APA agreement in effect. The five stages involved in the process are-

a) Pre-filing consultation
b) Formal application of an APA
c) Analysis and evaluation
d) Finalising and signing an APA and,
e) Execution, monitoring and review

The United States was the first country to adopt substantial penalties relating to transfer pricing and to require that companies maintain detailed documentation of their transfer pricing systems. Section 482 of the Internal Revenue Code permits the IRS to allocate items of income, deductions, credits, or allowances between controlled groups or organizations, to prevent evasion of taxes, or clearly to reflect the income of any controlled taxpayer, and, in the case of transfers of intangible property, to allocate income with respect to the transfer in a manner that is symmetrical with the income attributable to the intangible.

An MNC may spend a significant time and money working with the U.S. IRS, either providing the IRS with a transfer pricing study or negotiating an APA to satisfy the IRS that intra company sales are arm's length transactions and not designed to avoid the proper payment of business income taxes. While the taxing authorities in India have tried their level best to match the standards set by second oldest and one of the most experienced APA country i.e. USA, they still left some stones unturned that form a considerable part in the USA's APA regime. The success behind the APA provisions in USA is the fact it focuses on consumer satisfaction. The taxing authorities in the USA prioritize the fact that confidentiality is an essential part of any business and thus have provisions for non disclosure of this vital information. Whereas the same vitality has not been shown by the India taxing authorities as no measures have been to keep this information intact this makes the multinational vulnerable to the barbarous economic environment. Other fact that the Indian authorities have inconsistent with USA tax authorities is that the Indian act does not provide enough authority to reallocate any amount make any change to methodology used at the time if analysing and evaluating the APA application, unless they consult with the taxpayer. Whereas in USA the taxing authorities have enough scope as per section 482 to make necessary allocations and this authority has been referred as the only weapon available to the IRS.

Conclusion

The whole idea behind the introduction of APA in India is to determine an optimum Arm's Length Price and reduce the lengthy litigation process in tax matters. But the process of APA is complex per se. One such issue is pertaining to the document submission during APA. A question arises is that whether the documents submitted during an APA process can be used by tax authorities for initiating other tax proceedings? In most of the nations, the information pertaining to prospective business projections, financial audits is not shared but as far as the Indian rules are concerned, the law is silent. Therefore the government needs to address such a key issue and specially when there are cross border transactions involving related enterprises. Transfer pricing facilitates the need of transparency and effectiveness in the taxation process in cross border transaction. The investors should see from the point of view that it will make the growth process more conducive and foster the need of efficient taxation.

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