Emerging Transfer Pricing and International Tax Issues

While recent audits in India have seen transfer pricing adjustments relating to share valuation by companies in related-party transactions (Shell India case) and the tax treatment of contract R&D centres in the IT sector (Microsoft India case), other international tax issues like the treatment of royalties for software use (Nokia India case) and the out-of-court conciliation process (Vodafone case) also attracted considerable attention in 2013. The author considers these emerging issues in the context of transfer pricing provisions and international taxation in India, and suggests a possible course of actions on the basis of his analysis.

1. Introduction

When India introduced transfer pricing regulations in 2001, it could have not imagined that over a period of ten years it would witness an exponential growth in transfer pricing adjustments, which stood at approximately USD 12 billion¹ (INR 700 billion) in nearly 3,200 cases for assessment year 2009-10² alone. Also, now there is a transfer pricing adjustment in half of all cases selected for audit, as compared to one in four cases approximately four years ago.³ At the global level, according to PwC,⁴ India accounted for approximately 70% of the transfer pricing cases that originated in 2011, and stood third in terms of transfer pricing caseload in 2012, according to an Ernst & Young report.⁵

In light of these observations, two of the main themes which attracted considerable attention in the latest round of transfer pricing audits in India related to (i) the valuation of share sales by an Indian company in transactions with associated enterprises (Shell India case) and (ii) the tax treatment of research and development (R&D) centres in the information technology (IT) sector (Microsoft India case). While the valuation of shares alone is expected to have resulted in a transfer pricing adjustment amounting to INR 350 billion (out of total transfer pricing adjustments of INR 700 billion) for assessment year 2009-10,⁶ it is also estimated that approximately USD 2 billion (INR 120 billion) is tied up in litigation regarding the tax treatment of contract R&D centres in the IT sector.

In addition to these two transfer pricing themes, the latest round of audits also saw adjustments relating to international tax issues like the tax treatment of royalties for software use (e.g. Nokia India). The current financial year has also seen considerable discussion regarding the future course of action and the conciliation process in the famous Vodafone case dealing with indirect transfers of capital assets.

This article will discuss in detail these emerging issues in the context of transfer pricing provisions and international taxation in India, as seen in the latest round of tax audits.

2. Emerging Transfer Pricing Issues in India

2.1. Valuation of shares sold by an Indian company to its associated enterprise

According to the Ministry of Finance,⁷ for assessment year 2009-10, 27 cases of undervaluation of shares were subjected to appropriate transfer pricing adjustments in accordance with the Income Tax Act (ITA) 1961. This includes adjustment for companies such as Shell India Markets (INR 152 billion), Essar Groups (INR 80 billion), Vodafone India Services (INR 13 billion), HSBC Securities (INR 9.35 billion), Bharti Airtel, Standard Chartered Securities, Havells India and Patel Engineering.⁸

Reacting to draft assessment orders, Shell India and Vodafone India have already filed writ petitions before the High Court while simultaneously filing an application with the Dispute Resolution Panel in the event that the writs are cancelled. Shell India has argued that the move has no

---

¹. Using an approximate exchange rate of USD 1=INR 60 in light of the recent vulnerability faced by the Indian rupee with respect to the US dollar.
⁵. Ernst & Young Global Transfer Pricing Survey 2012.
⁷. Written reply by the Minister of Finance to un-starred Question No. 5157 in Lok Sabha (House of the People), Parliament of India, on 26 Apr. 2013.
⁸. Adjustment figures calculated from:
basis in law; it had received "capital" and did not earn any "income", and as only income may be taxed under tax law, it argued that taxation in this case is tantamount to taxing foreign direct investment.

The tax authorities, on the other hand, have argued that they are taxing mispriced or hidden "loans" and not equity investment. The tax authorities have stated that, in the case of Shell India, the INR 152 billion is a loan or "receivable" extended by Shell India to its parent company, as the valuation of shares issued to its associated enterprise was not carried out for arm's length consideration. The tax authorities concluded that in 2009, Shell India transferred 876 million shares to its Dutch-based associated enterprise at INR 10 per share. This was not the fair market value price of shares, which the Transfer Pricing Officer estimated to be approximately INR 183.44 per share. As a result, the Transfer Pricing Officer imposed a transfer pricing adjustment of approximately INR 152 billion.

Although the matter is sub judice and the details of the case are still not public, some of the issues that are expected to come up in the case include the definition of the term "international transaction", the applicability of transfer pricing provisions even where no "income" arises from a transaction, the appropriate method for share valuation, the recharacterization of transactions and secondary adjustments.

According to some observers, share sales to associated enterprises, being "capital receipts", are not an international transaction as defined under section 92B of the ITA. Section 92B(1) defines an international transaction as:

a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises.

Thus, a transaction having a bearing on profits, income, losses or assets seems to be an important condition to attracting application of the transfer pricing provisions.

This view was further substantiated by a recent (May 2013) ruling by the Income Tax Appellate Tribunal (ITAT) Hyderabad in the Vijai Electricals case.9 The Tribunal held that transfer pricing does not apply to investments in share capital overseas or to transactions where no income has arisen. The Tribunal further held that the amount paid for investment in the share capital of subsidiaries outside India is not in the nature of an "international transaction" as defined in section 92B. In support of its case, the tax payer also made reference to Central Board of Direct Taxes (CBDT) Circular 14/2001,10 as well as the Dana Corporation11 and Aminatit International12 advance rulings. In the Dana Corporation case, the Authority for Advance Rulings held that transfer pricing provisions do not apply if there is no income arising from a transaction.

However, the tax authorities seem to be deriving their definition of "international transaction" from a retrospective clarifying amendment introduced in section 92B by Finance Act (FA) 2012. According to clarification inserted, international transaction includes:

- Capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business...13

as well as

a transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date.14

Thus, capital financing and business restructuring – irrespective of bearing on profits – have been included under the definition of international transaction with retrospective effect from 1 April 2002.

That the tax authorities are banking on this clarifying amendment, can also be inferred from the fact that in June 2013 they amended the transfer pricing certification Form 3CEB15 to include information relating to international transactions in the nature of a guarantee; purchase or sale of marketable securities; issue and buyback of equity shares; optionally/partially/compulsory convertible debentures or preference shares; business restructuring or reorganizations; and deemed international transactions under a prior agreement. Also, this information is to be provided by a taxpayer irrespective of the bearing on profit, etc. The tax authorities can also find support in a June 2013 observation by the ITAT Hyderabad in the Northgate Technologies16 case that a share valuation should reflect the arm’s length price. The ITAT thus implicitly acknowledged the nature of a share transfer as an international transaction.

In addition to the issue of the definition of international transaction, the appropriate method for share valuation is also expected to generate much debate in the case. Various methods of share valuation, such as the EBITA multiple, price/earning multiple and discounted cash flow, are being used by the tax authorities, with methods such as the discounted cash flow method finding international acceptance as well. However, even if the taxpayer and the tax authorities both use the discounted cash flow method, many differences can still creep into the valuation mechanism depending on various discounting variables that are used in the process. In this regard, if the taxpayer wishes to argue that it has applied the discounted cash flow method...

11. IN: AAR, 30 Nov. 2009, Dana Corp. v. Director of Income Tax, 321 ITR 178 (AAR), Tax Treaty Case Law IBFD.
13. Explanation Clause (c) for sec. 92B inserted by Finance Act 2012 with retrospective effect from 1 Apr. 2002.
14. Explanation Clause (c) for sec. 92B inserted by FA 2012 with retrospective effect from 1 Apr. 2002.
15. CBDT Notification 41 of 10 June 2013.
within the guidelines prescribed by the erstwhile Controller of Capital Issues (CCI) Guidelines\(^\text{17}\) for share valuation, the question arises as to whether the Transfer Pricing Officer may question the CCI Guidelines as sufficient for purposes of prescribed methods for share valuation.

In this regard, there have been conflicting rulings by tribunals in recent times. In January 2013, the ITAT Chennai, in the *Ascendas (India)*\(^\text{18}\) case, held that the discounted cash flow method is a preferred method for share valuation as compared to the CCI Guidelines. The Tribunal concluded that the discounted cash flow method is in accordance with section 92C(1) of the ITA and that the Transfer Pricing Officer is not bound by the CCI Guidelines on share valuation, as the CCI Guidelines were issued for a totally different purpose and cannot be transported into transfer pricing methodology prescribed for determining an arm’s length price. On the other hand, only a few months later, in June 2013, in the *Northgate Technologies*\(^\text{19}\) case, while holding that share valuation must be at arm’s length, the ITAT Chennai endorsed share valuation under the CCI Guidelines to be at fair market value. Thus, preference of the discounted cash flow method over the CCI Guidelines and choosing discounting variables for the discounted cash flow are some significant issues that can come up in the case.

The recharacterization of transactions and secondary adjustments are also issues that can be raised in the case. According to the tax authorities, by selling shares at less than market value, a company compromises its asset base and thus it should be regarded as a mispriced or hidden loan which should be compensated by interest payment, which in turn calls for a further upward adjustment to the income of the taxpayer. As regards secondary adjustments, while Indian law is silent on the issue, the OECD holds that domestic laws should be decisive on the issue.

### 2.2. Taxing contract research and development centres in the information technology sector

The information technology and business process outsourcing sectors were expected to account for more than half of the total claims in transfer pricing deals in fiscal year 2008-09.\(^\text{20}\) According to another estimate, approximately USD 2 billion (INR 120 billion) is tied up in litigation involving software development centres.\(^\text{21}\) The transfer pricing treatment of captive R&D in the IT sector also becomes more significant in light of the fact that Indian software exports were close to USD 76 billion (INR 4,560 billion) in 2012-13, of which nearly one quarter were from captives.\(^\text{22}\) Recently, Microsoft India also was subject to transfer pricing adjustments of INR 51.35 billion for financial years 2006 to 2009 due to the application of the profit split method, as well as an upward adjustment on account of location savings. Using the profit split method in the Microsoft India assessment, the tax authorities argued that as 4.3% of Microsoft Global R&D was done in India, 4.3% of its global profit that was attributable to R&D should be deemed to be income of the Indian operations. Thus, the main issues of debate that are expected to come up in this regard concern the characterization of the risk profile of captive R&D centres, adjustments for location savings and the corresponding tax treatment of R&D centres.

The tax authorities have argued that the many so-called contract R&D centres are more than “contract” R&D centres, as they perform non-routine tasks, bear significant risks and contribute to the creation of unique intellectual property, which in turn is transferred to foreign affiliates without appropriate compensation. Therefore, these R&D centres, having a proportionate share of global profits, should attract tax adjustments under the profit split method. In the UN Transfer Pricing Manual,\(^\text{23}\) the authorities have held that R&D centres perform sophisticated and value adding activities, as well as attract, train and retain highly skilled professionals, and thus the authorities call for application of the profit split method. Taxpayers, on the other hand, have held that R&D centres are insignificant risk-bearing entities performing routine tasks, and thus should be compensated by their multinational parent companies on cost-plus markup and therefore argue that the transactional net margin method (TNMM) is the appropriate method to determine any transfer pricing adjustment.

The matter was further confused by the issuance of two circulars by the Central Board of Direct Taxes (CBDT) on 26 March 2013, wherein Circular 2 of 2013\(^\text{24}\) endorsed the profit split method as the preferred method for taxing contract R&D centres and Circular 3 of 2013\(^\text{25}\) mentioned six conditions to be “cumulatively” satisfied for characterizing a contract R&D centre as an insignificant risk bearer. These circulars were also in stark contrast to the position taken by the Rangachary Committee on Taxation of Development Centres and the IT Sector, which was formed by the Prime Minister in July 2012 and released its report in July 2013. That report concluded that the TNMM (rather than the profit split method) is a more appropriate method for taxing the captive units.

To synchronize its position on the issue, India revoked Circular 2\(^\text{26}\) on 29 June 2013 and amended and reissued

---

\(^{17}\) As governed by Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations 2000.


\(^{19}\) *Northgate Technologies* (2011).


\(^{23}\) UN Transfer Pricing Manual, ch. 10.


\(^{26}\) CBDT Circular 5/2013 of 29 June 2013.
Circular 3,27 thereby resolving certain ambiguities and doing away with the cumulative requirements to be met for characterizing a contract R&D centre as an insignificant risk bearer. Thus, now the profit split method is no longer a preferred method for the tax treatment of captive R&D centres. Broadly based on the recommendations of the Rangachary Committee, the Ministry of Finance also issued draft safe harbour rules on 14 August 2013, detailing circumstances in which the price declared by a taxpayer in a cross-border transaction with an associated company will not be questioned. In the case of software development services and IT-enabled services, if the total value of international transactions with the multinational parent company does not exceed INR 1 billion, tax officials will not question the income of the Indian unit if the operating profit margin declared is at least 20%. However, according to some observers, the exclusion of companies with turnover in excess of INR 1 billion would limit the number of those taking advantage of the safe harbour, and the proposed percentage seems to be on the higher side (with the ideal rate being in the range of 12-14%).28

As regards location savings, while the Indian guidelines do not provide any guidance on the issue, the Indian authorities in the UN Transfer Pricing Manual have advocated that the profit split method can be used to quantify and allocate location savings amongst the parties (with a functional analysis and the bargaining power of the parties as relevant factors for consideration), as benchmarking against local comparables does not take into account the benefit of location savings. However, a September 2012 ITAT Delhi ruling in GAP International does not seem to endorse this view of the tax authorities, as the Tribunal held that:

the intent of sourcing from low cost countries for a manufacturer/retailer is to survive in stiff competition by providing a lower cost to its end customers. Generally, the advantage of location savings is passed onto the end customers via a competitive sales strategy. [...] Thus in our view, no separate/additional allocation is called for on account of location savings.29

The same view is also reiterated by the UN Transfer Pricing Manual, which recognizes that location savings could lead to premium profits in the initial years, but with passage of time the premium would dissipate due to competitive pressures.

On the issue of assessing the risk profile of contract R&D centres, in a December 2012 ruling in GE India Technology Centre Pvt Ltd, the ITAT Bangalore held that:

The conduct of the parties is key to determine whether the actual allocation of risks conforms to contractual risk allocation. [...] The notion that risk can be controlled remotely by the parent company and that [the] Indian subsidiary engaged in core functions [...] are risk-free entities is something which needs to be demonstrated by the assessee.30

As the UN Transfer Pricing Manual also assigns considerable weight to evidence put forth to substantiate claims relating to which party exercises control, risk profile assessment seems to be an exercise that needs to be properly substantiated and documented.

3. Other Developments Regarding International Taxation in India

In March 2013, Nokia India was issued a notice by the tax authorities demanding that it pay approximately INR 20 billion related to the evasion of tax on royalty payments to its Finnish parent, Nokia Oyj, for downloading software on mobile devices manufactured in India since 2006. Royalties paid for downloading software attract 10% withholding tax. As part of the initial investigations, the tax authorities also concluded that Nokia India may have also flouted transfer pricing rules, which could result in adjustments amounting to INR 300 billion to Nokia India’s income.31

Nokia challenged the matter before the Delhi High Court, which handed the case over to the appeals division of the income tax authorities. However, in May 2013, the Commissioner of Income Tax (Appeals) dismissed the challenge. Nokia then stated that it would take the case back to the High Court. Efforts are also being made to reach a diplomatic solution under the 2003 India-Finland bilateral investment promotion and protection agreement and through a mutual procedure agreement under the India-Finland income tax treaty.32

Like other cases, the Nokia case also deals with interpretation of law, with the definition of the term “royalty” under section 9(1)(vi) of ITA expected to be main point of contention in this regard. In a similar case, Ericsson A.B.,33 in December 2011 the Delhi High Court held that consideration for the supply of software was not taxable as a royalty under either section 9(1)(vi) or the relevant provisions of an income tax treaty. However, a clarifying retrospective amendment of section 9(1)(vi) by the FA 2012 provides that:

[...] the transfer of all or any rights in respect of any right, property or information includes, and has always included, transfer of all or any right for use or right to use a computer software (including granting of a licence), irrespective of the medium through which such right is transferred.34

This clarifies that consideration for the use of or right to use computer software constitutes a royalty. As the amend-
ment has been made applicable with retrospective effect from 1 June 1976, it is expected to have a bearing on cases like *Nokia* relating to financial years 2006-2012.

In addition to the *Nokia* case, the *Vodafone* case (dealing with the indirect transfer of capital assets) also continued to generate high expectations regarding the future course of action in an effort to override the 2012 Supreme Court judgment in *Vodafone International Holdings v. Union of India*,

the retrospective amendments (of section 9 and section 2 of the ITA) introduced by FA 2012 attempt to bring under Indian jurisdiction all cross-border transactions involving indirect transfers of shares the underlying assets of which are located in India.

However, given the differences of opinion that have emerged between the legislature and judiciary on this issue, the Union Cabinet in June 2013 approved a proposal for non-binding conciliation with Vodafone India, the outcome of which will be brought back to the Cabinet; if both sides agree on the outcome, it will then be taken to Parliament. According to the proposal, the conciliation would be under the Indian Arbitration Law, and not under the UN Commission on International Trade Law (UNCITRAL) as sought by Vodafone.

To make conciliation possible, the government might also have to make amendments to the Income Tax Act and the Arbitration and Conciliation Act 1996, as the current law does not provide for conciliation between a firm and a sovereign state, and a uniform law might be needed for all companies that might seek conciliation following in Vodafone’s footsteps. One of the expected outcomes of the conciliation process would be a uniform law waiving interest and penalties in cases involving tax demands on account of retrospective amendments.

In addition, in one of first judgments on a similar issue since the Supreme Court judgment in the *Vodafone* case and the retrospective amendment by FA 2012, the Andhra Pradesh High Court recently held in the *Sanofi Pasteur* case that capital gains from indirect transfers of capital assets may not be taxed in India if the applicable income tax treaty does not so allow. Filing a Special Leave Petition against this judgment, the tax authorities have also requested the Supreme Court to reconsider its three-bench ruling in the *Vodafone* case, which in the opinion of the tax authorities, is in conflict with the five-bench ruling in the *McDowell* case.

### 4. The Way Ahead

The number of disputes between companies and the tax authorities has surged over the years. While there were 193,525 disputes involving INR 2,528.46 billion before the Tax Department in 2011, there were 30,213 disputes involving INR 580.33 billion at the level of judicial appeals. In addition, the FA 2012 seems to have opened a Pandora’s box of international tax issues. Many of the clarifying retrospective amendments introduced following the Supreme Court ruling in the *Vodafone* case seem to be giving rise to much confusion and litigation. Confusing and contradictory circulars issued by the CBDT seem to have further compounded this uncertainty. Different positions taken by government-appointed committees and tax authorities in regard of the UN Transfer Pricing Manual seem to have further aggravated the ambiguity regarding tax laws and guidelines in India.

Amendments to Form 3CEB, an expansion of the provisions attracting special audits and lowering the tolerance band (for attracting application of transfer pricing provisions) to approximately 3% (from 5%) are still more provisions that could lead to further litigation in the future if clarifying guidelines are not issued when needed.

However, the Tax Department is also making a conscious effort to address this situation. While in 2012 the ITAT decided to constitute separate benches in Mumbai, Delhi, Bangalore and Hyderabad to hasten the disposal of transfer pricing and international tax cases, the latest APA provisions, introduced by the FA 2012 and notified on 31 August 2012, seem to be a much more promising scheme. A frequently asked questions (FAQs) document on APAs was released by the CBDT in May 2013. However, with countries like the United States not supporting the Indian bilateral APA regime, some problems can arise for US-based companies. Nevertheless, still approximately 146 companies have already applied for an APA in the first year, of which approximately 79 companies were US companies seeking to enter into a unilateral APA with India.

Therefore, given the evolving nature of Indian legal provisions with regard to international taxation and transfer pricing, a suggestion can be offered that comprehensive documentation demonstrating the function, asset and risk profile be maintained by companies in order to avoid unexpected tax demands. Only time will tell whether the recent APA regime and safe harbour rules will be able to ease the process by reducing litigation and increasing taxpayer confidence. For the time being, all that can be said with certainty is that India needs to prepare itself for a considerable amount of debate and discussion regarding international tax and transfer pricing provisions, which will doubtlessly be keenly watched by local and global players alike.

---

38. Shankara, *supra* n. 4 (statement by Ministry of Finance).
40. Amendment to subsec. (2A) sec. 142 ITA 1961 with effect from 1 June 2013.