1. **Transfer Pricing in India under Indian Income Tax law**

1.1. **Congruence with OECD standards**

When TP was introduced in the Indian tax law, the regulations heavily leaned on the Organisation for Economic Co-operation and Development (“OECD”) guidelines on TP at that time, though there are some departures, which are explained subsequently.

In emerging economies, TP regulations can sometimes be seen as a deterrent to FDI. It is often feared that strict regulations on TP front could drive FDI to other economies, resulting in a prisoner’s dilemma for the tax authorities. However, by the turn of the millennium, with India having emerged on the league of economies that could not be ignored, it introduced the TP regulations more or less on the lines of the developed economies, without the fear of its impacting FDI flows in a significant manner. Nevertheless, certain stringent features such as Thin Capitalization Norms and Controlled Foreign Company Regulations are not yet introduced in the domestic laws of India.

The Indian TP norms hinge on the arms length principle. Unlike the US and Canada, where Global Formulary Approach (“GFA”) has acceptance in some provincial tax laws, Indian tax laws do not use GFA.

[.....]

1.2. **Hierarchy of methods**

The OECD guidelines prefer CUP to other traditional methods (RPM and CPM) and the transactional methods (PSM and TNMM) are considered as last resort methods

Under the Indian regulations, there is no statutory preference for any method to determine the arm’s length price. Instead, it advocates the usage of the ‘Most

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1 The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications - Eduardo Baistrocchi (Sweet & Maxell) 2008.

Appropriate Method’ to the transaction. Use of most appropriate method to compute the arm’s length price has been a subject matter of debate.

Further, practical experience shows that TNMM is by far the most widely used method in India. The paucity of publicly available data often leaves the parties concerned with no choice but to apply TNMM in preference to other methods. Moreover, in contrast to other methods, the comparability criteria for application of TNMM are also less stringent. A tax tribunal has observed that TNMM if used with appropriate adjustments to account for functional and other differences can provide solutions to insoluble transfer pricing problems. To this extent, there is no relegated preference to the transactional methods as compared to the traditional methods. Having said that, it is important (in the Indian context) that the taxpayer is able to establish that the method selected is by far the most appropriate one and enables computation of the arm’s length price.

The Indian regulations do not allow usage of more than one method. However, in practice, taxpayers sometimes use additional methods as supplementary methods, which are found to be useful when ultimately the tax authorities reject the first method and alternate methods. Thus, within the concept of Most Appropriate Method, Courts do accept usage of supplementary methods by taxpayers, which can be looked into when the primary method fails.

[.....]

1.5. Transfer pricing of intangibles

1.5.1. Introduction
The important issue concerning transfer pricing and intangibles relates to valuation of intangibles. It is extremely difficult to find similar transactions to arrive at an estimate of the intangible’s value. Transfer pricing regulations require the taxpayer to determine and apply the “most appropriate method”. Experience shows that in many cases, the Revenue has challenged the taxpayer’s choice of method. One of the challenges faced by the Revenue was determining arm’s-length prices for intangibles. Benchmarking intangibles like know-how, patents, copyrights and trademarks are often considered to be most difficult.

The transfer pricing methods RPM, CPM and PSM cannot be applied for benchmarking royalty payments. Typically, the CUP Method is applied for benchmarking royalty payments. To apply the CUP Method, there should not be any material difference between a controlled transaction and an uncontrolled transaction, and thus the CUP Method cannot be appropriately applied in the

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3 An internal analysis of all TP reports filed in the Delhi tax office found that TNMM was used in 92% of cases – News report /19 October 2008.
4 E-Gain Communications Private Limited (Pune Tribunal).
5 Philips software (Bangalore Tribunal).
case of royalty payments since it is extremely difficult to find similar transactions. Hence, an indirect approach is adopted, whereby royalty payment is benchmarked by comparing net operating margins of the taxpayer which is calculated after considering payment of royalty with the net operating margins earned by comparable independent companies. The issue with such an approach is that in a case where the taxpayer earns a low profit margin due to commercial reasons, there is risk that the TPO may hold that the price is not at arm’s length. In such a case, it is extremely difficult to argue on the arm’s-length nature of royalty payment and there is a high probability of challenge by the Revenue.

[…..]

2. Customs valuation in India

2.1. Customs valuation of goods in India vis-à-vis WTO prescribed methods of valuation

Customs valuation in India broadly follows WTO prescribed methods of valuation of goods. Historically, the first major attempt towards aligning customs valuation methodology in India with the WTO prescribed methods came in the form of the Customs Valuation Rules, 1988.

The Customs Valuation Rules, 1988 which were made under the Customs Act, 1962 prescribes methods for the determination of the value of goods imported into India. These rules created a ‘deemed value’ concept of valuation of goods which was at variance with the WTO approved ‘transaction value’ concept of valuation of goods. The Valuation Rules of 1988 used the ‘deemed value’ and ‘transaction value’ concept in different places, which resulted in several valuation-related disputes in the courts.

The effect of court decisions and the evolution of valuation law resulted in major amendments introduced being in 2007. The 2007 amendments formally articulated methods of valuation of export goods from India.

[…..]

Method of arriving at the transaction value Indian Customs Valuation Rules

Different methods for valuation of imported goods are prescribed under Rule 4 to Rule 9 of the Customs Valuation Rules viz;

— Transaction Value (Rule 4);
— Transaction Value of identical goods (Rule 5);
— Transaction Value of similar goods (Rule 6);
— Deductive Value (Rule 7);
— Computed Value (Rule 8); and
— Residual method (Rule 9).

Primarily, Rule 4 prescribes ‘Transaction Value’ of the goods to be taken as the value for calculation of duty on imported goods except in specified circumstances. Only if any of the conditions specified in Rule 4 are not met with, application of Rules 5 to Rule 9 is considered. The methods prescribed under Rules 5 to 9 are independent of each other and are applied sequentially. Only if conditions prescribed under one rule is not met, is the next one applied. However, power of rejection of declared value under Rule 12 and importer’s right to request for change in order of application of Deductive method and Computed value method are significant deviations in Customs rules (in India) vis-à-vis WTO guidelines on valuation.

[.. .]

2.3. Some special provisions

2.3.1. Special Valuation Branch (‘SVB’) of Customs

The SVB is an institution specializing in investigation of transactions involving special relationships and certain special features having a bearing on the value of import goods:

— Valuation of goods in ‘related party’ transactions; and/ or
— Valuation of goods in certain specific circumstances involving ‘cost and services’ supplied in relation to the goods.

SVBs are located in four major metro Custom Houses i.e. Chennai, Calcutta, Delhi and Mumbai and any decision taken in respect of a particular case in any of these major Custom Houses is followed by all other Custom Houses/ formations.

Apart from investigation of special relationship cases, SVB also handles complex cases of additions to declared transaction value. Specifically, in such cases where the additions sought to be made are considered to be in the nature of:

— Royalty and license fee, or where
— The value of any part of proceeds for subsequent resale, disposal or use of imported goods accrues to the seller, or where
— Other payments are made or are contemplated to be made (in future) by the buyer to the seller as condition of sale of goods.

Such cases are referred to the SVB. The SVB is an important element of customs valuation infrastructure in India and interaction with the SVB can be planned for efficiency and better management of valuation risk at the time of import of goods into India.
3. Interaction between transfer pricing and customs valuation

3.1. Valuation methods under Indian Transfer Pricing and Customs regulations and the key differences

In case of transactions with related parties (as described under customs valuation) or associated enterprise transaction, there is a significant interplay of transfer pricing of the goods in corporate tax and Customs valuation. At the current rate of taxation, customs duty rates ranges from 20% to twenty 25%, while the effective corporate tax rate is almost 34% percent. The difference in custom duty rates and corporate tax rates throws up tax planning opportunities. Generally, corporate tax and customs duty has an inverse relationship in the case of related party or associated enterprise transactions.

The table below gives an approximate comparison of various methods of arriving at the valuation of goods under Customs and Income tax law:

<table>
<thead>
<tr>
<th>Custom Valuation Methods</th>
<th>Transfer Pricing Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Transaction value of identical goods;</td>
<td>Comparable uncontrolled price method (‘CUP’)</td>
</tr>
<tr>
<td>— Transaction value of similar goods</td>
<td></td>
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<tr>
<td>— Deductive value</td>
<td>Resale price method (‘RPM’)</td>
</tr>
<tr>
<td>— Computed value</td>
<td>Cost plus method (‘CPM’)</td>
</tr>
<tr>
<td>— Residual method</td>
<td>— Profit split method (‘PSM’)</td>
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<tr>
<td></td>
<td>— Transactional net margin method (‘TNMM’)</td>
</tr>
<tr>
<td></td>
<td>— Such other method as may be prescribed by the Board</td>
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</tbody>
</table>