A critique of Transfer Pricing: It's not art, science - its magic!

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Transfer Pricing has been a cash-cow for everyone except the assessee's. More specifically: the auditors, the lawyers and the Revenue Department.

But it is not good law.

What ought to be economic analysis has been enshrined in laws couched in vague terms and open to subjective interpretation. All of which is exactly how a law should NOT be. What results is an utter waste of time, high-pitched assessments, increase in litigation et al giving it the ignominious distinction of having spurned a whole cottage industry of auditors and lawyers focussed only on TP (of whose cabal, I can claim membership too!)

Let me highlight a mere three examples to show the systemic problems prevailing in the current TP regime.

Today, many transfer pricing disputes end up with the use of TNMM (Transactional Net Margin Method), being one of the six prescribed methods. TNMM essentially computes the net profit margin of the assessee with the average net profit margin of the comparables. If the numbers are within a range (currently 3%), then it is held to be at Arm's Length Price (ALP). This is a very easy method to use in practice and hence is the favourite of both assessee's and Department alike. Asseessee's auditors do searches of paid databases and get comparable companies ('comparables') who have low profitability and the Department tends to chose comparables with high net margins. A barter of comparables ensues. At the TPO level, the DRP level and even at the ITAT.

The Department seems to adopt (also read as 'cut & paste'!) the same comparables list for all assessee's in a given sector for any given financial year. The big auditing firms tend to charge hefty amounts to do searches and come up with favourable comparables. The Courts, especially the Tribunal, decide on comparability of companies and these rulings form the bulwark on which further TP cases are argued. TP comparability cases are now snaking their way to the High Court, god forbid!

Comparability analysis is an incomparable farce given that non-technical people are using public accounts and spouting "functional" comparability of companies they have no clue of. Being from a software background, before my current tryst with law, I find the entire exercise laughable. Embedded software companies are compared with anti-virus application companies, BPO's are compared with financial analytics companies, Small consulting shops are compared with Infosys. I could go on but TP is like this Wild West of laws where anything flies as there is no written rule! This is blind leading the blind through a mist of economic detail, contracts, negotiations all of which are shown scant regard to. A common english phrase is 'you are comparing apples and oranges'. Well, in TNMM, apples and oranges are comparables as they are both fruits!

Long story short, it is unfortunate that with respect to TP, Courts are ending up essentially drafting the contour of the law and not merely interpreting it.

Another ridiculous area has been the brouhaha over 'brand' value. If a foreign car company has a distributor here, does the marketing spend of the Indian distributor contribute to the brand value of the foreign AE? Department feels it is so and came up with peculiar tests of adding under TP the advertisement expenditure which is spent by the assessee in excesss of comparables. And these comparables would be well-established Indian automobile companies like Hindustan Motors (ambassador cars!). Reality thrown out of the window once again.

One final hilarious TPism I would like to submit is the use of "filters" - which are used to eliminate comparables. There is NO prescribed rules for these filters. Dozens of filters such as turnover filter (comparables which have > Rs.200cr turnover to be eliminated), employee cost filter (comparables having < 25% of employee cost to sales to be eliminated) and so on. The best being Related Party transaction flter which is for a given comparable if more than 25% of transactions if with related parties, then the said company shouldn't be chosen as comparable. This 25% is a number which has now become 15% - how? Well, some Tribunal Bench decided so and then all cases thenceforth adopted it. No rhyme or reason. Same goes with the 'turnover filter'. What is the cut-off : some Benches say < 200cr; some say 10x assessee's turnover. Again, no rhyme or reason. This is TP remember.

I could go on and on but it suffices to say that the current house is not in order. In the words of a learned Tribual Member, TP is nothing but a form of GP (ie like gross profit estimation)!

Fact is that the TP methods specified are nothing but simple economics - if you can compare individual transactions, you will do so (CUP method). If you are a reseller, you typically compare gross-profits (RPM method) and so on. But why shoehorn all economic transactions into these methods? The number of variables and factors involved in these international transactions are so large that to try to fit them in some set of checkboxes will yield sub-optimal results, as we can see.

Well, no doubt it is easy to criticize but what is the solution? The fact remains that there are companies who shift their profit to foreign jurisdictions especially low-tax jurisdictions. There are companies who choose to pay "royalty" for years to foreign entities. Many such methods to move money out of India and not contibute to Govt's taxation pie exists. How to tackle them?

In my humble opinion, current TP law is not the answer. Two wrongs don't make a right. A few assessee's will exploit loopholes but the entire system need not be twisted in a Rube Goldberg solution to arrive at a fairytale ALP.

Let us consider a variety of practical approaches that can be taken to tackle the real problem of TP.

Firstly, to bring in certainity, the current safe-harbor rules must be revamped and made useful. The margin %'s today prescribed under safe-harbors are very high and make no commercial sense whatsoever (20% operating margin for BPO's, really?!). A simple suggestion would be for every year, selected industry-bodies in various sectors (NASSCOM in IT sector for example) along with Govt. statistcs office submit the average net profit margins for respective sectors. Studying both reports, an appropriate % can be notified by the Govt. as part of the IT Rules or via CBDT Notifications as a safe-harbor.

There has to be a practical approach here in arriving at some set rules. The Department needs to understand that artifically high profit margin %'s will actually be detrimental - if the figures are reasonable you will get a lot of MNC's simply accept and pay it while factoring it in their pricing.

Secondly, the entire system of TP assessment ought to be revamped. In case, a safe harbour (such as discussed above) is not chosen by assessee or if the AO has reasons to believe there is tax evasion and records the same with approval, a reference should be made by AO to an Experts Panel consisting of an economics expert and a techncal expert (sector-based), similar to how valuation on immovable property valuation is referred to Valuation Officer u/s.50C of the Act. Even an economic expert alone would be better than current Revenue officials and lawyers, each with their viewpoints, deciding on economics of international transactions. The Experts Panel can give an opportunity to the assessee while undertaking a review of assessee's international transactions and submit a final report. This can substitute the TPO order u/s 92CA

Thirdly, the Dispute Resolution Panel (DRP) can be gotten rid off as the current system does not provide any useful addition to the mix and rather is an additional burden on already over-burdened Department officials. The one thing the DRP does help the assessee is with an automatic stay for a period of time but this cannot be the main reason to sustain it. Too many cooks spoil the broth! Having 3 commissioners instead of 1 has not served any purpose in streamlining the system.

Fourthly, given the above changes, the erstwhile system of the AO looking at international taxation on case by case basis makes most sense. Scrapping the TP provisions altogether with prescribe methods seems to be a good start.

Fifthly, the Department should look into not pursuing litigation and instead provide reasonable settlement opportunities with the assessee. Other countries like Mexico and South Africa, for example have Tax Ombudsman offices play an active role in bringing assessee and Department together to arrive at a consensus. This calls for more of a change in approach than anything else. No other country has this much TP litigation - not even close.

The above suggestions need to be tweaked and the finer modalities need to be worked out. Safeguards can be incorporated while providing latitude for Department to pursue abherrants or extreme cases.

I feel these measures would work better than the current broken system. However, we seem to be unfortunately moving away from making it simpler and rather introducing more and more complicated provisins such as Secondary Adjustments and Thin Capitalizaton rules aping the OECD ideas. These ideas which may work well for the highly developed European markets having a handful of high-tech companies but are ideally not suited for widespread use in emerging markets such as India.

Some people think APA's are the panacea. But the system of APA's, while indeed very welcome, are not the end-all. Firstly, only few assessee's will qualify and have the wherewithal to go through APA process. Secondly, the Dept. also has only limited resources, officials or otherwise, to go through the APA process. APA's can never be a for-general public approach given its individualistic nature. Finally, the approaches lined out above will actually widen the tax base for the Department and in fact can live hand-in-hand with APA regime.

I believe the suggested measures will see reasonable increase in tax revenues, more certainity for the taxpayer, lesser disputes and put an end to pointless litigation. While as a lawyer this may mean biting the hand that feeds me, it seems to be the most ethical approach to abstinence from this self-created golden goose of TP.

Is anyone listening?

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