

Will 'Inter-quartile range' replace 'arithmetical mean' this budget?

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Finally, we have Argentina, Brazil, Germany and Netherlands at the semi-finals! The next week is going to be an exciting one as the world curiously waits to see the FIFA14 semi-finals and the final results. Equally, the world is eager to see the Budget from the Modi Government which will lay down the foundation for India's "Acche Din".

Times are changing - "corporate governance" and "transparency" are taking precedence globally over other things and hence it is time that we develop a policy that enables growth and prosperity for our people. And yes, tax will always rule the book as Governments manage their fiscal deficits, but how one manages will make the difference.

Having said that, here are my two bits from a Transfer Pricing (TP) perspective:

We have an "arithmetic mean" concept which challenges the basic tenets of an arm's length standard. As Almighty too did not attempt to make an exact comparable (we know that twins would not pass the strict comparability standards of the CUP method), why should a tax payer have their TP meet the "arithmetic mean" standard within the narrow tolerance band of 1 and 3 percentage points.

The irony in the application of our TP law is apparent. Let us assume that we have 10 comparable companies having operating margin ranging from 2% to 22% (inter quartile range say 8% to 16%) with an arithmetic mean of 15%. The arithmetic mean is an aggregation of all companies that are fit to be compared which means it is a "derived" number and not necessarily a margin that a third party earns. That be the case, a company making 2% is as much at arm's length standard as the one making 22%. In other words, it is impossible for all companies to meet the 15% target in an arm's length environment.

OECD, UN Manual and most regulations globally accept the conceptual framework of a "range" as compared to an "arithmetic mean". The use of range could vary from a "full range" to an "inter- quartile range". Businesses are driven by commercial considerations and

in a perfect market, even with related parties transactions, one would find companies earning margins ranging from lower to higher numbers earned by comparable companies. Tax authorities around the world believe so and have therefore embraced the range concept. It is a point that we cannot ignore as we walk down the growth path.

If we are looking at significant inbound investments which pay an effective tax of approximately 42% (considering the DDT), one would have to allow them the same level playing field that our companies get to play when they invest outside India.

The Corporate world have to now comply with the new regulations (Companies Act, Clause 49 and RBI) that require documenting, disclosing and reporting as to whether their related party transactions meet the arm's length standard. These regulations have been primarily introduced to protect the minority shareholder's interest. The arm's length standard applicable for these regulations is quite broader as compared to the Income Tax Act. It is also a good idea to harmonise the Income tax provisions with these regulations that point towards a "range" concept.

It is desirable that the Indian regulations recognise the use of inter-quartile range (instead of arithmetic mean) to determine the arm's length price. When I make this statement, I am equally mindful of the fact that much rigour would need to be introduced in "selection of comparable companies" to ensure optimum outcomes that meets the flexibility for tax payers without costing the exchequer.

An icing on the cake would be to allow multiple year data for comparability analysis without any conditions. The rigour in the selection of comparable companies and the Industry in which one operates should provide sufficient data points for use of multiple year data.

I was also keen to talk about the TP Customs harmonisation but would leave it for some other day. Currently, I will eagerly wait for my favourite team to win the World Cup and our FM to roll out the growth oriented Budget which will lay the foundation for India to win the real World CUP.