Director's cut to be screened more closely by taxman

Corporate chiefs such as **Reliance Industries** Mukesh Ambani, **ITC Ltd** YC Deveshwar and **Tata Consultancy Services** N Chandrasekaran would need to justify in unprecedented details why they take home heavy pay packets if the companies they run are to avoid reassessment of income and extra tax demands.

In the first audit cycle after executive pay was brought under transfer pricing provisions in the Finance Act of 2012, tax officers are now preparing to go deep into the returns of managerial remuneration companies have filed last November for 2012-13 to verify the reasonableness of corporate salary spending.

Tax officers unimpressed by the justifications given could disallow as business expenditure what they think is the excess remuneration and add the same to the taxable income of the companies. Such re-computation of income called transfer pricing adjustments would lead to higher tax claims.

Income tax department sources told FE that field officers would start assessing returns on managerial remuneration in July to take up possible cases of audit and transfer pricing adjustments.

"Businesses have to justify directors' remuneration in great detail to avoid transfer pricing adjustments. There are no hard and fast rules on how to justify the remuneration but when shown to an independent third party, it should appear convincing as reasonable compensation for the services rendered by the executive or promoter manager," said an official of the tax department, who asked not to be named.

Justifying the handsome salaries given to top executives is going to be a tough call for India Inc as assessing the contribution and potential of employees is highly subjective and would vary from company to company. Since directors' remuneration is now classified as a related-party transaction between the company and the director, it has to be on an arm's length basis — that is, the amount has to be as if the parties were unrelated. It should be close to what would have been charged between independent parties in an open market.

Using comparable salaries of peers in similar companies for benchmarking and proving the arm's length nature of executive pay is difficult. This is because such remunerations vary widely. For example, TCS CEO & MD Chandrasekaran received Rs 11.68 crore in 2012-13, compared with Rs 65 lakh Infosys CEO & MD SD Shibulal took home and Rs 4.93 crore accepted by Infosys whole-time director BG Srinivas.

In the case of Ambani, who accepted Rs 15 crore in 2012-13, less than half of what has been approved by RIL shareholders, it is hard to find a private sector oil and gas company of similar size. Cairn India, which is several notches below RIL in market capitalisation and different in the product mix, paid its then CEO Rahul Dhir Rs 17 crore.

The idea of subjecting executive pay to transfer pricing rules is to prevent shifting of profits to related parties, eroding the tax base and jeopardising the interests of the larger shareholder community of an enterprise.

“Benchmarking directors’ remuneration is one of the most difficult aspects of domestic transfer pricing. A CBDT clarification on ways of benchmarking directors’ remuneration would be much appreciated. Meticulous documentation may be required whichever method is used,” said Amit Maheshwari, partner, Ashok Maheshwary & Associates.

“It is impossible to comply with transfer pricing norms in executive remuneration,” said a tax expert with one of the big four accounting firms, who didn’t wish to be identified.

Considering the difficulty in benchmarking compensation of top executives with their peers in other companies, the finance ministry is now favourably examining some of the suggestions it received to reduce confusion and possible litigation.

“One view is that in the absence of comparable external data on executive pay (external comparable uncontrolled price or CUP), listed companies could use shareholder approved managerial remuneration (as an internal comparable uncontrolled price or internal CUP) to establish the arm’s length nature of the compensation,” said a government official, who declined to be named. The government is yet to issue any guidance on this. This method, however, would not be applicable for unlisted companies.

Experts said that some of the ways to justify the arm’s length nature of executive pay could include use of external HR compensation survey reports, references to the pay received by executives prior to them becoming directors and compliance with the ceiling on total managerial remuneration as required by the Companies Act (11% of net profits).

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