CHAPTER 3: EVOLUTION OF GLOBAL TRANSFER PRICING REGULATIONS

EVOLUTION OF TRANSFER PRICING

Parent Companies of a MNE Group usually have sub-holdings and joint ventures in several countries. Production, services and other activities may be concentrated in centers operating for whole group or specific parts; intangibles, developed by the group entities may be concentrated in certain group members; finance companies may operate as internal banks; production of semi-finished goods and final products may take place in separate countries. With regard to the decentralization of authority, groups may range from highly centralized to structures with high degree of decentralized and profit responsibility allocated to individual companies.

The issue of transfer pricing has become a significant topic in economic planning for any Corporation and also for host country. Several reasons can be attributed for these phenomena. One of the major reason is the ongoing (re)location of the production of final products and components to appropriate territories for lower production costs, infrastructure facilities, tax incentives and systems, skilled labour force, etc. which are located in different countries.[68] In the second place, the concentration of service functions within a MNE also plays an important role in this regard. In a particular situation, MNE creates its own service organisation as competence center for providing services to its own group companies. The most common services being Networking, Back office Data Processing, Accounting and Taxation services etc. Thirdly, the relatively new phenomenon - 24 X 7 round the clock - Trading in commodities and financial instruments, which were made possible by modern means of communication. With these change in manufacturing footprint and business modalities, the consumer and seller of goods and services are expected to be located beyond their respective geographical boundaries. Hence, the correctness of transfer prices for these goods and

[68] Manufacturing strategy is decided based on capability and cost of the production unit. Hence appropriateness of production unit for a particular product line is decided by businesses based on both the metrics.

services will be critical for the profitability and sustainability of the respective units.[69] Study shows that over 60 percent of the international trade is carried out between Multinational Enterprises (MNE).[70]

The intra-group transactions, entered into between two or more enterprises within the same MNC group, have added some new challenges for the taxation authorities as well as for the Group. Since, the prices are set within an organization (i.e. controlled) for related party transaction, it is perceived that the typical market mechanisms for establishing price for third parties may not apply. The choice of the transfer price will affect the allocation of the total profit among the units of a company. The challenges have increased because the enterprises started establishing businesses beyond their host countries. This is a major concern for fiscal authorities who worry that multinational entities may set abusive transfer prices on cross-border related party transactions to reduce taxable profits in their jurisdiction. This has led to the rise of transfer pricing regulations and enforcement, making transfer pricing a major tax compliance issue for multi-national companies. Unfortunately, the perception of the taxing authorities of host countries is that the profits disclosed by such enterprises in host countries are not correct and are controlled by manipulative pricing by the entities within themselves to transfer the profit from a high tax country to a low tax country.[71] The perception has resulted into skepticism amongst the revenue authorities and

[69] *Report on Transfer pricing by Ad hoc group of experts on International Cooperation in Tax Matters,* Tenth Meeting, Geneva (September 10-14, 2001) *available at* http://unpan1.un.org/intradoc/groups/public/documents/un/unpan004399.pdf (Last accessed on May 15, 2013)

[70] The term MNE not only covers big corporate houses like, SHELL, IBM etc., but also smaller companies with one or more subsidiaries or permanent establishments (PE) in countries other than where the parent companies or head office are located.

[71] *See generally,* ERNST & YOUNG, 2014 GLOBAL TRANSFER PRICING TAX AUTHORITY SURVEY, *available at* http://www.ey.com/Publication/vwLUAssets/EY-global-transfer-pricing-tax-authority-survey/$FILE/ey-2014-global-transfer-pricing-tax-authority-survey.pdf (Last accessed on January 15, 2015)

all intra-group transactions are scrutinized with skepticism. This perception also advocates that the manipulative pricing has resulted into erosion of tax revenue of the host country. Further, political reasons have also played a role in increasing the importance of transfer pricing globally. Authorities of respective countries continue to allege that foreign enterprises, active in the country, pay substantially lower amounts of income tax in comparison to the local companies.

It is observed that in some situations, various departments of group entities negotiate with each other like independent parties since they have their own profit responsibilities. The transfer price resulting from such an independent negotiation is equally acceptable from the business economics point of view. However, there is a probability that revenue authorities may reject commercial transfer pricing approach, if the same is in conflict with the prevailing tax rules since a commercial transfer pricing approach, not consistent with prevailing transfer pricing rules, will lead to multiple rules and management and scrutiny of such transfer pricing approach may lack standardized approach. In such circumstances, companies may either adopt an system acceptable to the tax authorities or may maintain two separate systems, one for the purpose of reporting and other for tax purpose. However, the researcher would like to recommend the Corporates to follow a commercial system approach since it has a favorable impact on the attainment of economic objective[72] of the company.

Indeed, transfer pricing provides opportunities for MNEs to shift profits from a high tax rate country to a country with a low corporate tax rate or to a country with tax incentives for certain activities. Also, decisions of a holding company

[72] Maximisation of shareholders value is one of the economic objectives of any company. Example is provided in Table

may aim to avoid taxation through various business decisions[73]. It is to be noted that Tax planning is one of the considerations[74] which are pertinent for an MNE in setting up a transfer price. Many MNEs prefer a good relationship with the tax authorities of the host countries where they are operating. The taxation uncertainties in operating countries are avoided by the MNEs and usually maintains a well-documented and simple transfer pricing system, which ultimately helps these Companies to attain the business objectives.

However, sometimes Transfer Prices are, in a pejorative sense, considered as a method adopted by MNEs for shifting of taxable income from a country, located in a high taxing jurisdiction, to a low taxing jurisdiction in order to reduce the overall tax burden of the group. The following example will illustrate the objective of a manipulative Transfer Pricing.

Company "S" had two controlled units. One is manufacturing unit situated in Country "I" and the distribution unit is located in the country "A" where the ultimate user of the finished goods are located. The group earns Rs. 100/- from both units resulting in an earning of Rs. 200/- for the group as a whole. In case the tax rates in both the countries are same, the Profit after Tax for the group will be the same. Now, consider a situation wherein the rate of taxation in the country of manufacturing unit is 30% while that of the distribution company is 20%. In such a situation, the post-tax profit in the first country would be Rs 70/- while in the second country it would be Rs. 80/-resulting in a combined post-tax profit of INR 150 if both these Companies are under same group. Thus, tax has brought down the profit by INR 50. Let us consider a situation whereby the entire profit of the manufacturing company is transferred to the distribution company. In such a case, the post-tax profit for the group would be INR 160 since the effective rate of taxation on group profit would be 20%. Obviously, by interposing tax heavens in the transaction it may be possible to increase the post-tax profits still further.

[73] Decisions may include slowdown of one unit to improve utilization of another unit, change in debt-equity ratio, utilization of shared services set-up by another unit etc.

[74] Other considerations include decisions about manufacturing strategy, improving shareholders wealth, supporting global customers, acquisition strategy etc.

There are several other factors a company may consider beside taxation factors for selecting the country for declaring profits[75]. Few of such factors are discussed below:-

1. Shifting of funds to manage volatility of foreign currency;
2. To overcome restriction on repatriation;
3. In case of existence of minority shareholding, the transfer price mechanism is used to lower the share of profit for the minority local shareholders;
4. On some occasion, the Company may not want to attract lot of public attention due to higher profit in a country;
5. Transfer pricing can be used to formulate a predatory pricing strategy

Therefore from the above discussion, it is observed that there are various motives for a multinational enterprise for formulating a controlled transfer pricing mechanism. Therefore, to conclude that taxation is the sole motive for deviation from an independent pricing mechanism may be construed as an over simplification of the issue. Whatever may be the reasons for manipulative transfer prices, the ultimate fact is that it results in adversely affecting the tax base of developing or underdeveloped countries involved. Obviously, the remedy available to tax authorities is to have an aggressive policy to counter this abuse. However, there is a possibility that any such aggressive policy might work as a deterrent to the investment sentiment in the country.

The large scale tax avoidance practices used by MNEs came into limelight when the giant drug MNE, Glaxo Smithkline[76] agreed to settle with the

[75] DELLOITTE, GLOBAL TRANSFER PRICING COUNTRY GUIDE, 2014 *available at* http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-transfer-pricing-country-guide-2015.pdf (Last accessed on May10, 2015)

[76] Kavaljit Singh, *The Growing Abuse of Transfer Pricing by TNCs* (May 28, 2007) *available at* http://www.countercurrents.org/kavaljitsingh280507.htm (Last accessed on October 28, 2010)

government of USA to pay a huge amount for settling a long disputed case of Transfer Pricing agreement between its UK parent company and its American subsidiary. The investigation authority of US tax administration revealed that the company had paid a huge transfer price for purchase of one of its drugs from its parent company. This was mostly done to reduce the tax liability in US.

The motive for charging high prices between the associated enterprises is mainly to reduce the tax liability without any changes in operating profitability of the holding company. One of the data selected for this study revealed in the box below.

> The prevailing tax rate in Korea was 20% and tax rate of India was 33%. Company X in India would purchase product Y from its AE in Korea at a price of 100 $ per unit, the selling price of the product in India is 80$ per unit. In this case, although the Indian company will make a loss of 20$ per unit but will generate a Deferred Tax Asset on that loss @ 33% to the tune of 6.7$ per unit, whereas the tax liability of the Korean firm would be only 4$ per unit considering the Korean unit's operating profit is 20% on sales. Therefore at consolidated level, the profit of the Group will not have any impact since 20$ loss in India will be offset by 20$ profit in Korea. The net income after tax will be higher for the group due to 2.7$ lower tax liability in this case and the company's distributable profit will be higher by that amount.

In addition to the motive as discussed above, there may be additional motives of the MNEs for fictitious transfer pricing. In case where the parent company does not wish to re-invest the profits earned in a company and there is a restriction for repatriation of the profits, the MNE will chose another way to repatriate the profit by setting a manipulative price to transfer the profits and avoidance on distribution tax in those countries. Also by way of allocation of cost to companies located in high tax rate jurisdiction, tax liabilities may be reduced. The repatriation of profit will also reduce the foreign currency reserve of the host country.

The researcher has observed in one of the cases studied by him,[77] that a subsidiary of an MNE situated in host country and entering into some small transactions is also in a position to transfer a high profit to the group. This can be done by way of providing marketing and after sales services to associated enterprises without any monetary benefit. In an instance, the marketing department of the local company was providing marketing services to the Group and the units controlled by the Group was selling the goods and services to the ultimate customers without entering any recordable transactions with the local Company and therefore the rules of the Transfer Pricing were not applicable on the local Company. It was also observed that at a group level, various decisions are taken to decide the profitability of the company situated in the host country to minimize the tax liability for the group.

Given the magnitude of manipulative transfer pricing, the Organisation for Economic Co-operation and Development (OECD) had issued a detailed guidelines with an objective to control the base erosion and profit shifting from the host country.[78] Transfer pricing regulations are highly stringent in developed countries like US & UK. However, the developing countries are lagging behind in enacting regulations to check these abuses. India framed the regulation related to Transfer pricing in 2001[79] whereas countries like Pakistan, Nepal and other developing countries are yet to formulate any strategies to curb the abuse of manipulative transfer pricing. Bangladesh has

[77] S India Private Ltd. (SIPL) was engaged in providing installation and commissioning services to various companies, who would directly purchase components in complete knocked down condition from associated enterprises of SIPL. The final price for the customers would be divided in such a way that overseas entity gets a share which will help them to earn a targeted margin. The residual amount will be the charges for installation and commissioning. The warranty liability would bear by the local entity and therefore was responsible of replacing the faulty parts, if required. SIPL would purchase only spares from overseas entities. Hence the transactions with associated enterprises were limited and not exceeding the threshold limit for Transfer Pricing scrutiny.

[78] Final BEPS Report, OECD (2015) *available at* http://www.oecd.org/ctp/beps-2015-final-reports.html (Last accessed on August 23, 2015)

[79] Income Tax Act, 1961 § 92 read with Income Tax Rules, r. 10

enacted Transfer Pricing rules only in 2014.[80] The abuse of transfer pricing mechanism could be drastically curbed through proper co-ordination amongst the international taxing authorities.

However, it was also realized that tax planning is only one of the series of considerations which are relevant for MNEs while doing business globally. Many MNEs prefer to maintain a good relationship with the tax authorities of the countries where they are active. Certainty about the amount of tax to be paid is a top priority for large Companies and they usually operate through a well-documented, straightforward Transfer Pricing system, which is in the first place a requirement of sound business economics.[81] However, it was observed that these documentations are limited to the country where holding Company is situated or the exposure is high. That resulted into litigations in other countries, which led to higher tax expenses for the group.

The approach of Indian judiciary mainly hovers around to compare the net profit margin of a company and benchmarking the same company with an unrelated/uncontrolled company without adjusting the relevant adjustments for volume, economic and other functional differences[82]. This situation has created serious challenges for MNCs and also for judiciary which led to litigations. There are some merits in the hypothesis of Indian judiciary that MNEs are capable of shifting profits in low tax jurisdiction. However, in absence of scientific approach to find the methodology used to shift the profits, sometimes the reasons and decisions pronounced by the Income Tax department lack facts and evidence and therefore the taxpayer gets benefit of doubt and goes scot free.

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[80] Income Tax Ordinance, 1984 § 107A to 107J (Bangladesh)

[81] See generally, ERNST & YOUNG, 2014 GLOBAL TRANSFER PRICING TAX AUTHORITY SURVEY, *available at* http://www.ey.com/Publication/vwLUAssets/EY-global-transfer-pricing-tax-authority-survey/$FILE/ey-2014-global-transfer-pricing-tax-authority-survey.pdf (Last accessed on January 15, 2015)

[82] Philips Software Center Private Ltd v. ACIT, (2008) 119 TTJ (Bangalore) 721.

In the meeting of Public Accounts Committee dated 29.08.2013, the following data was shared with the members of the Committee.[83] On being asked about the details of the cases pending with Appellate Authority and Settlement Commission for the years 2007-08 to 2011-12, the Ministry of Finance in its written reply, furnished as under :

[83] Public Accounts Committee, *87th Report on Tax Administration* (presented to Lok Sabha and laid in Rajya Sabha on 29th August, 2013) *available at* http://saiindia.gov.in/english/home/Public_Folder/PAC_Reports/Revenue/87th%20report.pdf (Last accessed on October 10, 2013)

TABLE 3: Case pending with Appellate Authority and Settlement Commission

F.Y.	Numbers of appeals pending before Appellate Authorities on last day of F.Y.					No. of Cases pending before Settlement Commission
	CIT (A)	ITAT	High Court	Supreme Court	Total	
2007-08	130358	34667	31590	3344	199959	2064
2008-09	158031	31384	34986	3984	228385	1310
2009-10	180991	24693	30544	5009	241237	1235
2010-11	187182	31121	35272	5803	259378	1061
2011-12	230616	29842*	30213*	5943*	296614	1130

Data as on 30.12.2011

When asked about the percentage of orders which went on appeal to the Commissioner of Income Tax (Appeal) during the last five years, the representative of the Ministry of Finance (Department of Revenue) deposed before the Committee as:

> *"In 2007-08, about 22.65 per cent of our cases went in appeal to CIT appeal. In 2008-09, 16, 96 per cent cases went and in 2009-10, 21.81 per cent cases went. In 2010-11, it was 20 per cent and in 2011-12, it was very high, 32.33 per cent were taken on appeal".*[84]

In the absence of a scientific approach to the Transfer pricing solutions which is acceptable to both exchequer and the companies, litigations are increasing which is impacting overall investment sentiments and stability of economic conditions. While analyzing some of the recent judgments, it was observed that documentation and incorrect methodology was one of the major reasons for dispute.

[84] *Ibid.*

In one the landmark cases of *Philips Software v. ACIT*[85] the tribunal while deciding the case held that the motive of tax avoidance is not required to be demonstrated during transfer pricing provision but the same should be demonstrated at the time of assessment. The Assessing Officer need to provide that the assessee manipulated the price to transfer its' profit outside India. It was also observed that since the company enjoyed exemption u/s 10A of Income Tax Act, the provision of transfer pricing will not be applied. It was further held that unless Assessing Officer/Transfer Pricing Officer communicates to the taxpayer about the violation of the four conditions prescribed under Section 92C (3) of The Income Tax Act, 1961, the transfer pricing order would be void.

In *Mentor Graphics* v. *DCIT*,[86] the assessee was rendering contract software development support service to its parent company. Most of the business risks were borne by the parent associated enterprise (AE). All intangibles were the exclusive property of the parent AE. The assessee only maintained and deployed necessary human resources and infrastructure for development of software. The above characteristics of the controlled transactions were not kept in mind by the TPO in selecting comparable. It was held that the first step in the determination of arm's length price is to analyse the specific characteristics of the controlled transaction. Without proper study of a controlled transaction, no meaningful comparison or location of comparable is possible. In this particular case, a simple comparison of the transaction to "software supply" is not sufficient since there are hundreds of companies supplying softwares where the circumstances and background may vary. Hence, a simple comparison of selecting "Software Service" as comparable will result in an erroneous comparison.

[85] (2008)119 TTJ(Trib)721 (Bangalore)
[86] (2007) 109 ITD 101 (Del)

AGGRESSIVE TRANSFER PRICING POLICY[87] AND ITS IMPACT

FDI inflow has a direct impact on the economic development of the host country. Various studies on this issue found that FDI has a direct link with economic growth of a host country. Using cross-section data and Ordinary Least Square regression it was found[88] that FDI has a positive effect on economic growth in host countries using an export promotion strategy but not in countries using an import substitution strategy[89]. FDI has a positive effect on economic growth but the magnitude of the effect depends on the human capital available in the host country.

It may be argued[90] that economic growth and FDI inflow are synonymous. FDI inflows can affect the economic growth of the host country in several ways. The purpose of this section is to provide a description of the potential growth enhancing the effect of FDI.

FIRM SPECIFIC ADVANTAGES, KNOWLEDGE CAPITAL AND EXTERNALITIES [91]

Firstly it is easy and inexpensive to transfer knowledge-capital assets to new geographical locations. Since it has a joint character, it can create a flow of services at several different production facilities without affecting its productivity. The characteristic knowledge capital provides the firm possessing it with an ability to transfer production to foreign economies. The fact that the MNEs can use their knowledge capital simultaneously in multiple

[87] Aggressive stance of the revenue authorities about cross border related party transactions and taxing abruptly is termed as "aggressive transfer pricing policy" in this section

[88] The effects of FDI inflows on host country, a study conducted by Andreas Johnson, 2005

[89] Abdul Khaliq & Ilan Noy, *Foreign Direct investment and Economic Growth, Empirical Evidence from Sectoral Data in Indonesia*, (2007) *available at* http://www.economics.hawaii.edu/research/workingpapers/WP_07-26.pdf (Last accessed on September 28, 2013)

[90] *Ibid*

[91] Foreign Direct investment flows and Economic Growth", Magdalena, Radulescu, Annals of the University of Oradea, Economic Science Series/15825450, 20080901.

locations provides an incentive to provide horizontal FDI implying that the same production process is duplicated in several different locations.

The non-rival characteristic of technology implies that MNEs try to protect their technology by using brand names and patents. [92] Spillover of technology is externality that can occur through several different channels including imitation, reverse engineering, and supplier linkages. When spillover does occur, it implies that the MNE is unable to internalize all the returns to its technology resulting in a positive externality since the social return on investment is higher than the private return. It primarily is the positive externalities from technology spillover that allows FDI to enhance the rate of economic growth.

FDI can also generate an inflow of physical and human capital because as the size of the host country physical capital stock increases the productive capacity of the host country also increases since Solow model[93] rules out capital as a source of long-run per capita growth. In such a framework, FDI can only affect growth through an inflow of capital in the short run while the economy is in transition towards a steady state.

However it is the relationship between foreign and domestic investment that determines the ultimate effect on the physical capital of the host country. The question is whether the domestic and foreign investment in the host country is complementary or is a substitute. Theoretically, both the alternatives are plausible. For example, if an MNE finances its investments through borrowing in the host country financial market, it can result in an increase in the interest

[92] "Foreign Direct investment flows and Economic Growth", Magdalena, Radulescu, Annals of the University of Oradea, Economic Science Series/15825450, 20080901.

[93] Solow model is a growth model developed by Robert Solow and Trevor Swan, which predicts that in long run income differences between countries are due to differences in savings, productivity or population growth. The model can be found at http://www.unc.edu/~jbhill/Solow-Growth-Model.pdf ((Last accessed on September 12, 2014)

rate causing domestic investment to be crowded out. This is an example, how FDI can have a negative impact on the economy of the host country. On the other hand, MNE operations can stimulate host country production in additional industries through the creation of demand for intermediate goods. If the host country firms can supply these intermediate goods, result wil be an increase in domestic investment.

FDI AS A SOURCE FOR INCREASE IN REVENUE FOR THE EXCHEQUERS

Any increase in investment will have multiple effects on the increase in revenue for the exchequers of the host country. In case of FDI, the exchequers will be benefited in following ways besides Corporate Tax:

1. Direct Taxes on the Employee Salary;
2. Wealth Taxes;
3. Indirect Taxes in the form of Excise Duty, Customs and Sales Tax.

Recently, the counter-productive economic implication was observed due to Vodafone dispute[94] which resulted innegative investment sentiments in the country[95]. The researcher submits that any business house would like to have consistency in Tax policies and would try to avoid any future litigation due to retrospective change in tax policies which can lead to future uncertainties.

ARM'S LENGTH PRINCIPLE- A TECHNICAL MATTER OR BEHAVIORAL ISSUE

In recent years, there has been a growing awareness amongst the multinational companies to become respected corporate citizens and

[94] Vodafone International Holdings B.V. v. UOI and Anrs, 2012 (107) CLA 63 (SC)
[95] *Finance Ministry says no going back on Vodafone Tax Issue*, BUSINESS LINE (March 19, 2012)

therefore these companies has been formulating stringent code of ethics for their day to day business functioning. One such code for MNEs amongst others is "Obey the Law of Land". This code suggests that the Companies should follow the law of the land where they are doing business. However, many Corporates are not following their own policy in strict sense when it comes to setting Transfer Price for an intra-group transaction. In many cases, the overall economic objective of a company which includes "increasing the shareholder's value", supersedes the ethical value of the company. The difference between tax planning and tax evasion has a very thin line and in some cases, it has been crossed by some of the Corporate bodies which leads to believe that multinational enterprises can evade a large portion of their statutory tax burdens by manipulating transfer prices in cross- border transactions. The reasons for shifting profits between jurisdictions using the transfer pricing is the differences in Corporate Tax rates. The following example will elaborate the statement:-

Facts of the case study S India Pvt Ltd (SIPL),[96] a subsidiary of S Ltd - Switzerland had established Indian operation in the year 2000 by registering SIPL as subsidiary of S Ltd. The Company was providing erection and commissioning services to its customers for products imported from its group company in Complete knocked down (CKD) condition directly by these customers. There was limited direct transaction with associated enterprises since customers used to directly import the components in CKD condition. The Company sustained losses for 7 continuous years and started paying MAT from 8th year. The matter was referred to TPO who recommended an additional liability of Rs.22 crores after comparing the Company's profitability with its comparable company. He observed that although the transactions with associated companies were to the tune of only 5 crore, he believed that

[96] This is an unpublished case study conducted by the researcher. The background material is available in file with author. The business methodology is narrated in judgment of ITA no 2333/MUM/2008

the local transactions should be scrutinized due to lower profitability. The matter was referred to the Chief Commissioner of Income Tax, where the company pleaded that third party transaction was outside the purview of the TPO to recommend an adjustment. The Chief Commissioner after due hearing disallowed the adjustment recommended by the TPO for the local transactions and continued with the adjustment for the transactions related to associated companies. The demand was reduced from Rs. 22 crores to 2 crores and the Company got a relief from the department to the tune of Rs. 20 crores. On scrutiny of the transactions of the company, the following was revealed:-

- The marketing department of the Company would generate enquiries for supply of full system;
- The marketing department also used to negotiate and finalise the orders on behalf of overseas AEs;
- The Company officials used to generate orders on the associated companies for supply of materials from respective plants. These orders were generated on behalf of the customers;
- The logistic department used to work as a consultant for the customer for all logistic support including but not limited to customs clearance and transportation upto site of the customers;
- Payment to AEs used to be settled by the customers through letter of credit;
- SIPL used to install the system for which the local Companies used to get installation charges. However SIPL was also responsible for all the warranty claims.

After detailed scrutiny of the abovementioned transactions, it was observed that based on internal understanding the source plans used to get 85% of the total agreed price for supply of materials in CKD condition which used to be

cost plus 13% mark-up for the source plant and the local unit used to get only 15% of the price irrespective of higher cost of their services. The local unit not only incurred cost for installation, which was paid to third parties, but also had to maintain a separate logistic department, service team and also had to bear the cost of warranty which included but was not limited to replacement of spare parts, if needed during the warranty period.

In case of rejection of material due to quality issue, the company was responsible for sending back the material for replacement. Therefore all the logistic cost used to be borne by the Indian company. The above free of cost transactions resulted into unmatched cost against the income resulted into losses. However, the transactions were not recorded in the books and they used to be outside the scope of Transfer pricing assessments. In this case, the local unit could be termed as dependent agent in the host country for the unit located overseas.

Therefore, from the case study stated above, it was evident that although there were very limited related party transactions recorded in the books of the local company, which could fall under purview of transfer pricing scrutiny, the *modus operandi* resulted in the erosion of profits from the host country.

TRANSACTIONS REDUCING CORPORATIONS TAX LIABILITIES IN HOST COUNTRIES

Cost Allocation

Cost allocation for "shareholder activities" in the name of "Management charges". These are charged by the group company for controlling the activity of the unit which is generally for the benefit of the shareholders. Therefore, the rationale for charging these costs to the business unit results in the erosion of profit

Thin Capitalization

Thin capitalization[97] is another methodology. Without investing in a capital intensive industry, long term capital requirement are funded by providing promissory notes and other short term loans extended by another unit within the group.

Managerial Services, Other Activities

This includes management of local activities for another business unit without charging anything for that activity and managing local distributors without earning any agency commission. In some cases transfer of intangibles takes place in tax haven countries where the subsidiary of the group company is situated. It is established that in the case of transfer or licensing of intangible property, the income of the transferor or licensor had to be commensurate with the income attributable to the intangible. The commercial terms for any transactions are changed in such a way that the Working capital requirement for the business unit in host countries is increased which is ultimately funded by the group company to earn more interest. It is observed that Transfer Pricing policy is mainly aimed at consolidation of cash for distribution of income to the shareholders. *Firstly*, by underpricing intra-company sales and overpricing intra-company purchases, a subsidiary located in a high tax country can increase the multinational's overall profit since the parent's gain in after tax-profit is higher than the subsidiary's net of tax loss. *Secondly*, for setting artificial transfer prices is the existence of tariffs. If the tariffs are based on price of a commodity, under-invoicing of intra-company sales may be a tax saving device. *Thirdly*, motivation for using transfer prices to shift

[97] *Thin Capitalisation Legilalisation: A Background paper for Country Tax Administration*, (OECD Publication, 2012) *available at* http://www.oecd.org/ctp/tax-global/5.%20thin_capitalization_background.pdf (Last accessed on April 4, 2013)

profits arises when international tax codes imply double taxation of a subsidiary's distributed profits. This is the case when the host country of an affiliate collects withholding taxes on dividends that are not credited in the home country.

A similar situation occurs when the home country employs a deduction rather than a credit system to tax foreign income. In both cases, a multinational company saves taxes if it repatriates profits by setting artificial transfer prices rather than by paying dividends. The so-called super royalty provision looks at the future actual profit to determine the price of the transaction at the date of the contract. It means that a price may be adjusted for tax purposes if the profit of the transferee is higher than expected at the time of the transaction.

It is evident that the MNE can not only transfer profits in the form of direct transactions, but also is in a position to transfer profit in an indirect way. For example, a subsidiary of an MNE situated in host country and entering into some small transaction is also in a position to transfer a high profit to the group. This can be done by way of providing marketing services without any agreement. The marketing department of the local company can provide marketing services to the group company and the group company can directly sell the goods or services to the ultimate customer without involving the local company and therefore avoiding the rules of the transfer pricing.

The above issues have developed skepticism amongst the tax authorities. Since stringent rules have been created by the developed nations, the developing nations are also creating similar stringent rules to counter the tax evasion. This has resulted into a situation where for any multinational enterprise transaction, the "burden of proof" now lies on MNC which creates a challenging situation and taxation instability for the Companies operating in different countries. To avoid such a situation, multinational enterprises should adopt a policy whereby an independency in business decisions by the unit in

host country should be allowed which is the starting block of OECD guidelines.[98]

OVERVIEW OF INDIAN LEGISLATION

In Union budget of the year 2001, Government of India has replaced and inserted Section 92 to 92F[99] to provide detailed statutory framework of transfer pricing provision in the Act. The sections have been effective since April 1, 2001. While enacting the detailed transfer pricing provision, new section 271AA, 271BA and section 271G were inserted to provide penal provisions for non-compliance of Transfer Pricing provisions. The rules regarding transfer pricing along-with the interpretation of such provisions were released by Income Tax (21st amendment) Rules, 2001 and also added new rules viz., 10A to 10E in Income Tax Rule, 1962

The intra-group cross border transactions[100] are covered under provision of Section 92 to 92F under Income Tax Act, 1961. The multinational enterprises are affected by the transfer pricing regime which had made transfer pricing the most important international tax issue due to introduction of the provisions. The framework of Indian regulations is based on the Organisation for Economic Co-operation and Development (OECD) Guidelines [101] which includes transfer pricing methods, describes the documentations and penal provisions are introduced for non-compliance of the rules.

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[98] Review of Comparability and Profit Methods, Revision of Chapter I-III of the Transfer Pricing Guidelines, OECD publication, 2012, publication available at OECD.org

[99] These sections were introduced vide Finance Act, 2001, with effect from April 1, 2002.

[100] The definition of International Transaction contained in subsection (1) is reasonably wide and includes all transactions having a bearing on profit, income, losses and assets of such enterprises

[101] Transfer Pricing guidelines for Multilational Enterprises and Tax Administrators, OECD publication, available at OECD.ORG

The Indian Transfer Pricing provisions encompass various transactions whether international or specific domestic transactions and prescribes various methods for computing arm's length pricing for those transactions.

Type of transactions covered

In accordance with Section 92B of the Income Act, 1961, 'international transaction' covers transaction between two (or more) associated enterprises involving the following transactions:-

1. Sale & purchase or lease of tangible or intangible property;
2. Services;
3. Cost-sharing agreements;
4. Lending or borrowing of money;
5. Any other transaction having a bearing on the profits,
6. Income, losses or assets of such enterprises.
7. Business restructuring or reorganization
8. Guarantee

The meaning of associated enterprises is provided in s.92A of the Income Tax Act, 1961. In accordance with the section, an associated enterprise, in relation to another enterprise, means an enterprise-

a) Which participates directly or indirectly in the management or control the capital of the other enterprise
b) Any other enterprise, which directly or indirectly participates in the management or control the capital of both the enterprises

In such a situation, all enterprises which are in common management for an enterprise will be termed as an "associated enterprise". Till financial year (FY) 2011-12, transfer pricing regulations in India were only applicable on international transaction by virtue of s.92B of the Income Tax Act, 1961 and

not on domestic transaction. However, insertion of s.92BA in the Income Tax, 1961, 'specified domestic transactions' has been brought under the purview of Transfer Pricing regulations, if the aggregate of such specified domestic transaction exceeds INR 5 crore. The transactions covered under specified domestic transactions include:[102]

1. All expenditure for which deduction is claimed
2. Any transaction related tax incentives, for example, incentives covered under Section 80-IA and SEZ units (Section 10AA).
3. Any other transaction as may be specified.

Associated enterprises

In accordance with Section 92A of the Income Tax Act, 1962, Associate Enterprise means any enterprise which directly or indirectly controls or participates in the management of another company. However there are certain parameters laid down in the act for the purpose:-

1. Direct/indirect holding of 26% or more voting power;
2. Extending loan of more than 51% of the book value of the assets;
3. Guarantee by an enterprise for 10% or more of total borrowings

In case more than 50% of the board of directors of the enterprise are appointed by the other enterprise

4. Complete dependence on the intellectual property
5. Majority of raw material/sale of manufactured goods by an enterprise from/to the other enterprise at prices and conditions influenced by the latter.
6. The existence of any prescribed relationship of mutual interest.

[102] This amendment is applicable for FY 2012-13 and subsequent years.

The arm's-length principle and pricing methodologies

In accordance with Section 92C(1) of the Income Tax Act[103], the method of calculation of arm's length price includes six methods, the detail of which are provided in Rule 10A and Rule 10B of the Income tax Rules:-

1. Comparable uncontrolled price (CUP) method.
2. Resale price method (RPM).
3. Cost plus method (CPM).
4. Profit split method (PSM).
5. Transactional net margin method (TNMM).
6. Such other methods as may be prescribed. However such methods should be calculated considering an unrelated party would have charged in such circumstances,

Under the Income Tax Act, no methods are considered to be higher or of less priority for this purpose. The most appropriate method should be selected based on the nature of transaction as well as other relevant factors.

However, the Act provides some degree of flexibility in comparability calculation. The variation between arm's length pricing determined and actual should not exceed 3%(earlier 5%) or as may be notified by the Central Government in Official Gazette as per the provisions of s. 92(c)(1) of the Income Tax Act, 1961.

Documentation requirements

Extensive documentation has been suggested by the Act[104] irrespective of the volume of transaction. The documents include a Transfer Pricing study covering business background, ownership structure, details of transactions.

[103] *See* Circular No. 14 of 2001
[104] Income Tax Act, 1961 § 92D read with Income Tax Rules 10D

The rule also suggests that the assessee should conduct an extensive transfer pricing study which should cover various details and analysis.

Accountant's report

All taxpayers are required to obtain an independent accountant's report in respect of all international transactions. The form of the report is provided in the Rules.[105] The objective of this report is to certify the correctness and completeness of the list of transactions provided by the taxpayer. It is pertinent to mention here that even when an entity is enjoying a tax holiday, it is required to comply with all the transfer pricing provisions including but not limited to documentation.

Burden of proof

The onus of proving the appropriateness and correctness of arm's length price derived for any related party transaction lies primarily on the taxpayer himself unless it is rejected by the Assessing Officer[106]. The taxpayer during the audit proceeding is responsible to prove to the assessing officer of the correctness of the arm's length pricing based on the data, information, comparability study and any other documents available in their possession. Therefore, documentation is utmost important in this situation. In case the assessing officer forms an opinion that the documentary evidence submitted by the assessee does not conform to the requirement or does not help to form an opinion about the correctness of the arm's length pricing, the assessing office can pass an adjustment order which can increase the taxpayer's liability including imposition ofpenalty and interest in accordance with the provisions of the Income Tax Act.

[105] Income Tax Act, 1961 § 92E read with Income Tax Rules, R. 10E

[106] Income Tax Act, 1961, § 92D and 92E provides requirement of documentation for proving the arm's length pricing in case of International or Specified Domestic Transactions. In the case of SSP India Pvt Ltd Gurgaon v. Assessee on 29 May 2015, the Delhi Bench of ITAT has commented on Burden of Proof and responsibilities of both the parties in this regard.

Advance Rulings

In recent years, an Authority for Advance Ruling has been constituted to facilitate ascertainment of the Income tax liability for non-residents and specific categories of residents. This has helped these tax payers to plan their tax liability in advance and also helped them to avoid any uncertainties and litigations in future. The taxpayers can seek advance ruling from the AAR on questions or facts evolving from a transaction or proposed transaction which are important for determination of his tax liability.

Tax audit procedure

Transfer pricing audit is done on selected assessee. Currently as per internal guidance of Income Tax Authorities, assessee having international transaction of more than INR 50 million is selected for detailed scrutiny. The threshold limit of INR 50 million is subject to change based on the ongoing review of the limit. An audit note is sent to assessee within 6 months from the end of the financial year in which the return is furnished specifying the details of the documents, records and other relevant information that are required to be submitted before the assessing officer.

The transfer pricing audit is not done by the Corporate tax officer. As per the process and infrastructure developed by the Income Tax Department, trained and special officers designated as Transfer Pricing Officers (TPO) have been nominated to conduct the detailed scrutiny for the international transactions. The tax assessing officer (AO) refers the case to TPO for the detailed scrutiny after obtaining approval from the Commissioner of Income Tax.

Once the matter is referred to the designated TPO, he or she will send a notice to the assessee for submission of records and evidence with respect to these transactions. The ultimate objective of the TPO would be to form an opinion that the international transactions carried on by the taxpayer are

priced at arm's length and no duress or influence played a role in deciding the pricing or other factors important for the profitability of the assessee. The TPOs are instructed to seek opinion from technical experts if they consider it necessary for completion of the assessments in complex cases. TPOs are also authorized now to conduct surveys and inquiries which are important for completion of the assessment.

Appeals procedure

In case the taxpayer is not satisfied with the TPO's order, the taxpayer may file an appeal to the Commissioner of Income Tax, who is also termed as Appellate Commissioner, within 30 days from the date of receipt of such impugned order. However, in case the order is passed by an officer of the rank of a Commissioner, the same needs to be appealed to Tribunal only. With effect from the year 2009, an alternate Dispute Resolution Panel (DRP) has been established to ensure a fair and expeditious resolution of all disputes involving transfer pricing and taxation on foreign companies. As per the rules sets out in DRP procedures objection to the order passed by the assessing office may be filed by an eligible assessee with the Dispute Resolution Panel[107]. The taxpayer needs to communicate its decision to the Assessing officer within 30 days of the order receipt by the assessee. In case the assessee opts for referring the matter to DRP, the DRP within 9 months from the referral, would pronounce its decision to AO.

The taxpayer can appeal to the appellate tribunal against the order passed by the DRP if it/he is aggrieved by such order[108]. The order passed by the appellate tribunal can be challenged at High Court and finally to the Supreme Court. The Income Tax Act, 1961 has provided a similar appellate right to the revenue also.

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[107] Income Tax (Dispute Resolution Panel) Rules, 2009 Rule 4
[108] Income Tax (Dispute Resolution Panel) Rules, 2009 Rule 14

Additional tax and penalties

There are various stringent penalties proposed in the Income Tax Act for non-compliance of the provisions of the said Act for Transfer Pricing. The various kinds of penalties prescribed are discussed hereinbelow:-

1. 2% of the Transaction value for failure to maintain proper documents and records
2. 2% of the transaction value for non-submission of the documents and information during Audit
3. 2% of the Transaction value for failure to disclose any transaction in the Accountant's report
4. In case of adjustment proposed by TPO, 100-300% of adjusted amount is levied as penalty
5. For non-submission of accountant report, INR 1,00,000/- is proposed to be levied as penalty
6. Further to the direct penalties proposed, any enhancement of Income resulting from the assessment does not qualify for the tax holidays.

Resources available to the tax authorities

There are highly trained officers available with the Income Tax Authorities for the purpose of ensuring compliance and Audit of the Transfer Pricing provisions of the said Act. Indian Authorities are providing extensive training to its officers to upgrade their knowledge and understanding about the subject matter to ensure that tax revenues are secured and stop abuse of transfer pricing mechanism to shift profit out of India.

Use and availability of 'comparables' information

The responsibility and onus is on taxpayer to maintain comparables along with other Transfer Pricing documents to prove that transfer pricing for international transaction is at arm's length price. Comparables are

considered to be the most important element for defending arm's length pricing. However in India, Indian authorities used to deny accepting any foreign comparables as an evidence for arm's length pricing till the recent amendment in rules[109].

The source of comparables is mainly from electronic databases like Capitaline®, Prowess®[110] etc. which provide detailed financial information required for comparables. The financial information and information with regard to related part transactions of public companies is also available by paying a certain fee to Registrar of Companies.

Liaison with customs authorities

The Indian Finance Ministry in response to the complex matters of related party transactions for both revenue departments viz, Customs and Income Tax, has set up a joint coordination committee involving officers from both departments to exchange information and sharing ideas. Periodical meetings are held between these two departments to discuss issues which need attention. For improvement of coordination and exchanging information, both departments have been instructed to exchange information and share the database available to them. The ministry has also planned to conduct various training programs for both departments to enhance their skills with regard to complex matters like transfer pricing. This step was a long awaited one which will foster the harmonious coordination between both the stakeholders who have conflicting objectives. This action from the ministry is a wake-up call for the Corporates to prepare a comprehensive Transfer Pricing policy which will cater to the requirements of both statutes and would be able to satisfy the arm's length pricing appropriateness to both authorities.

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[109] Income Tax Rules, Rule 10D(3)

[110] Capitalise and Prowess is database provides fundamental and market related data for Indian Listed and unlisted companies classified under different industries, alongwith powerful analytical tool.

Safe Harbour Rule

Safe harbour rules are defined under Section 92CB of the Income Tax Act[111]. Safe harbour rules provide a set of conditions for specific nature of transactions for specified industry, which are not subject to detailed scrutiny for reviewing the appropriateness of the arm's length pricing if certain conditions are satisfied. The salient features of safe harbour rules[112] are as below:-

1. Once adopted by an assessee, the rule will be applicable for 5 years on the assesee;
2. An assessee cannot opt for safe harbour rule for a period more than 5 years. Therefore, this rule is only applicable for 5 years during lifetime of an assessee.
3. Transactions upto 500 crores are only eligible for adoption of safe harbour rule.

TABLE 4: The eligibility, conditions etc. are as below for adoption of safe harbour rule

International transaction	Threshold limit prescribed	Safe harbor margin
Software development services & information technology enabled services with lower risk	Upto Rs. 500 Crore	20% or more on total operating costs
	Above Rs. 500 Crore	22% or more on total operating costs
Knowledge processes outsourcing services with minimum risks	25 % or more on total operating costs	
Loan to a non-resident wholly owned subsidiary	Interest rate equal to or greater than the base rate of SBI as on 30th June of the relevant previous year	
	Upto Rs 50 Crore	Plus 150 basis points

[111] This section was inserted by the Finance (No.2) Act, 2009 with retrospective effect from April 1, 2009 and empowers the Board to make safe harbour rules.

[112] Rules 10TA to 10TG have now been introduced in the Income Tax Rules, 1962, w.e.f., 1.4.2013 which deal with these safe harbours

helpful for the assessee to avoid disputes as long as the prices are in accordance with the APA.

Case Laws

Transfer pricing provisions in India were enacted in 2001[115] and since then, several rounds of transfer pricing audits have been completed. There have been few cases which have helped to understand certain important approach of judiciary and transfer pricing authorities. These precedents have also helped the Indian financial system to establish some important transfer pricing principles. Some of these principles are:-[116]

1. Preference for transaction based assessment principle over entrepreneurship approach
2. Importance of comparables and their functional similarity
3. Need for adjustments for dissimilarity of condition

After passing through the initial phase where availability of data was one of the important aspects, authorities are now moving towards importance of understanding complex situations including control, use of intangibles and cost allocations for forming an opinion about arm's length pricing. Some of the landmark judgments in this regard are summarized below:-

Quark Systems Pvt. Ltd.[117]
The company was engaged in providing services to an AE. It has selected TNMM for determination of arm's length pricing. The company had submitted data of comparable companies in support of their margin. Out of the comparables selected by the company, one of the companies was rejected by the authorities since that company was sustaining losses in consecutive years. Aggrieved by the order, the company filed an appeal with the appellate

[115] Income Tax Act, 1961, § 92 to 92D
[116] Refer Table 2 of Introduction Chapter
[117] Quark Systems Pvt Ltd v. DCIT, 2010 (4) ITR (Trib) 606 (Chandigarh)

tribunal challenging the selection of the comparable companies by the TPO due to functional dissimilarities and net worth etc.

The tribunal while remanding the order back to the revenue, agreed to the need of proper functional analysis for arriving at a conclusion on comparability of arm's length pricing. The tribunal also recommended that the taxpayer should be given an opportunity to rectify any mistake during audit proceedings. The above judicial pronouncement has established the following principles:-

1. Need for proper functional analysis for selection of comparables
2. Need of following substantial justice in case of *bona fide* mistakes
3. The assessee should be given an opportunity to reject its own selected comparables on the ground of new facts and merits during the audit proceeding.

Schefenacker Motherson Limited[118]

Schefenacker Motherson Limited (SML) was engaged in the manufacturing of auto components for Indian automobile companies in India and for its group entities. SML selected TNMM as methodology to prove the arm's length pricing for its group entities. SML also used Cash profit as a profit level indicator to substantiate the comparables due to capacity adjustment. While deciding the case in favour of the assesse, the tribunal mentioned the need of functional analysis and analysis of profits for various kinds of businesses. This judgment was precedent for using cash profit as PLI.

Skoda Auto India Private Limited[119]

The Appellate Tribunal held that, Skoda Auto India Private Limited was engaged in business of manufacturing passenger cars. In the first full year of

[118] 2009 TIOL 376 ITAT (Delhi)
[119] (2009) 122 TTJ (Trib) 699 ITAT (Pune)

commercial operations, it entered into international transactions with two associated enterprises and imported almost 98.55% of total raw material required, and this was materially different from import content of the raw materials for the comparable companies selected by the revenue authorities, which ranged from 26% to 56.83%. The business model of the comparable companies selected by the revenue authorities was fundamentally different and no comparison was possible without adjusting the import components.

Economic adjustment should be allowed where it is necessary especially where capacity adjustment needed for unusual high start-up cost. If the comparable data is not in public domain, the taxpayer cannot be expected to have the full data approximation and assumption is expected in case on unavailability of data in public domain wherever applicable the benefit of ±5% range should be accepted for comparability purpose. This ruling was quite important for the start-up companies where economic adjustments are keys for comparability.

IL Jin Electronics (I)(P) Ltd.[120]
While contesting the TPO's order in appellate tribunal, the company argued as below:-

The actual purchase price paid by its AE to the unrelated vendors should be considered that working capital differentiates between the company and the comparable companies needs to be considered in arriving at the arm's-length operating margin under the TNMM.

Any upward adjustment to the import price should be based only on 45.51% of the company's turnover and not the total turnover. The tribunal commented that an alternative method for TP analysis would have been ideal in the given situation like RPM or CPM. However, in absence of information with regards

[120] (2010) 36 SOT (Trib) 227 (Delhi)

to the same, the alternate methodology could not be used to check the appropriateness. Hence, in this given situation TNMM is the best methodology to follow.

Gemplus India Pvt. Ltd.[121]

This was a landmark ruling which involves in intra-group management services. In this case, the company entered into a management service agreement with its AE for receipt of services in finance, accounting, sales and support and other administration support.

The TPO found that there were no evidence that the AE has actually provided the services and no specific benefit was derived by the Indian entity. The company also could not demonstrate the necessity of these services since it had already employed professionals in this field.

The Appellate Tribunal adjudicated the case in favour of the tax department. This ruling has laid down some principles applicable for service transactions which should at least meet the following criteria:-

1. The need for the services obtained could be established;
2. The services should be actually received;
3. The benefits derived should commensurate with the charges paid.

From the ruling of the Tribunal, it is observed that service receipts and benefits accrued to the taxpayer from such services rendered needs to be established through appropriate documentary evidence, although various Tribunal rulings has indicated that the commercial prudence of the taxpayer cannot be questioned.

[121]2010 (10) TMI 184 – ITAT Bangalore

Logix Micro Systems Ltd.[122]

In this case, Tribunal while upholding the TPOs contention of adding notional income due to significant outstanding receivable observed that any amount outstanding beyond normal credit period should be considered as an interest loss to the company and therefore should be added back as an notional income for the company.

L'oreal India Pvt. Ltd.[123]

The importance of this ruling was that the tribunal accepted in this case that applicability of Resale Price Method for deriving arm's length pricing will be ideal for the business whereby the taxpayer imports the goods from its AE and resale in Indian market without any value addition. Initially, TPO had rejected the applicability of RPM in this case and derived arm's length pricing through TNMM method. During the hearing, tribunal observed that the company had produced certification from its AE disclosing itss margin which is between 2%-4%. The tribunal had further observed that the TPO had never disputed these certificates and hence the rejection of the methodology and the application of TNMM was found to be arbitrary.

The tribunal further observed that the margin earned by AEs was reasonable and therefore the contention of the TPO that AE was earning higher margin was not based on the facts of the matter. This ruling was important in another way too since the Tribunal had accepted the facts that sustaining operating losses was not always contributed by the international transactions.

[122] 2009 (42) SOT (Trib) 525 (ITAT Bangalore)
[123] ITO v. L'oreal India Pvt Ltd [2012] TAXMANN (Trib) 192 (Mumbai)

OVERVIEW OF REGULATION IN OTHER COUNTRIES

United States[124]: Taxing Authority and Tax Law

Taxing authority: Internal Revenue Service (IRS) is responsible for tax administration in the country. The taxing law in the country is Internal Revenue Code (IRC) of 1986. The relevant tax law is Internal Revenue Code (IRC) of 1986, The Transfer pricing rules and regulations are provided in Treasury Regulations 1.482, 1.6662,1.6038A, 1.6038C. The procedures are detailed in Revenue Procedure 2006-54, 99-32 and 2006-9.

In 2007, IRS observed that Cost Sharing Arrangements (CSA) was required to be considered as "Tier I" issue, and thus intensified audit scrutiny on all such issues. Initially a Coordinated Issue Paper (CIP) was released on 27 September, 2007 as guidance for the tax examiners for CSA related matters The Department of Treasury and the IRS released temporary CSA related regulations with effect from 5 January 2009 (TD 9441, 74FR 340) and thereby repelling all earlier regulations in this regard. Subsequently, the final CSA regulations were issued on 16 December 2011. Additional temporary and proposed regulations were published on19 December 2011. The final CSA regulations were mostly in line with temporary CSA regulations and the additional temporary and proposed regulations were published to make some minor changes to the final regulations. The final regulations authorised the IRS to make periodic adjustments and formalize other new requirements for compliance. The new rules were made effective from 1 January 2007, and applied to the tax years beginning after 31 December 2006. In conjunction

[124] *Available at* https://www.irs.gov/Tax-Professionals/Tax-Code,-Regulations-and-Official-Guidance (Last accessed on May 12, 2015)

with the new CSA regulations, the IRS also issued Announcement 2006–50, which contained a proposed list of "specified covered services" that relate to a specific cost–based method. In accordance with the new services regulations, stock–based compensation were required to be considered as part of total costs. The final services regulations were issued on 31st July 2009.

OECD Guidelines treatment

According to the IRS, the transfer pricing laws and regulations are fully consistent with OECD Transfer Pricing Guidelines (OECD Guidelines[125]). However, the OECD Guidelines are not directly relevant for domestic pricing purpose. However, if taxpayers pursues with competent authority for relief from double taxation or for a bilateral APA, the OECD Guidelines are quite relevant and the taxing authorities follows the OECD guidelines to be compliant with the international practice.

Priorities/pricing methods

The acceptable pricing methodologies for tangible goods include CUP, Resale Price, Cost Plus, CPM, Profit Split, and unspecified methods. The IRS accepts the Comparable Uncontrolled Transaction (CUT), CPM, Profit Split, and unspecified methods for intangible goods. For services, the IRS accepts the Services Cost, Comparable Uncontrolled Services Price, Gross Services Margin, Cost of Services Plus, CPM, Profit Split, and unspecified methods. CUT, Income, Acquisition Price, Market Capitalization, Residual Profit Split and unspecified methods[126] are acceptable for CSAs. A taxpayer

[125] *OECD Guidelines for Multinational Enterprises and Tax Administration* (OECD, 2010)
[126] Unspecified methods are similar to those defined as "Any other Methods" under Indian Income Tax Act, 1961 in relation to arm's length pricing

may adopt a "best method rule" under the rules provided for the purpose for determining the appropriate method to be applied by the taxpayer for each intercompany transaction.

Transfer pricing penalties

In accordance with IRC §6662, Taxpayers are liable for a penalty of either a 20% or 40% of the underpayment, for underpayment of tax, or for a valuation misstatement. No penalty is prescribed for not maintaining proper documentation, however, proper and complete documentation may help the taxpayer to avoid penalty.

Penalty relief

A taxpayer may avoid penalties by adequately disclosing the facts like not following the rules and regulation or of a substantial understatement of Income Tax. IRS Form 8275[127] has been prescribed for the purpose. However, no penalties can be avoided by only disclosure, if the penalties are leviable for misstatement or negligence. A Tax payer may be relieved from penal provisions, if he can prove that he had acted on good faith or there was a reasonable cause for the non-compliance. The regulation further stipulates some guidance, especially, maintenance of appropriate documents for establishing the reasonable cause or good faith.

Documentation requirements

Although transfer pricing documents are not made mandatory under US transfer pricing laws, a taxpayer can avoid penalties if it maintains a relevant and current document. The transfer pricing rule provides that the taxpayer is bound to submit the documentation to the IRS authorities within 30 days from

[127] *Available at* https://www.irs.gov/Tax-Professionals/Tax-Code,-Regulations-and-Official-Guidance (Last accessed on April 12, 2015)

the date of request during IRS examination. The documentation, as mentioned, must be current and existence when the return is filed. However, there is no need to disclose the existence of the documents in the tax return and neither the documents are required to be filed with the return,

In practice, it is advisable that taxpayer maintains an appropriate documents for avoidance of penalty. A document may be termed as appropriate if all the information listed below are captured in the document. The documentation and information listed below may support the argument that the taxpayer had acted in good faith and had reason to believe that the pricing charged was at arm's length.

The principal documents required by regulations are:

An overview of the taxpayer's business and an analysis of the legal and economic factors affecting pricing may include the following:-

1. A description of the organizational structure;
2. Any documents explicitly required by regulations (e.g., CSA documents);
3. A description of the pricing method and reasons why the method was selected (a best method analysis);
4. A description of alternative methods and why they were not selected;
5. A description of controlled transactions and any internal data used to analyze them;
6. A description of comparables used, how comparability was evaluated and any adjustments, if required;
7. An explanation of any economic analysis and any projections used to develop the pricing method;
8. Any material data discovered after the close of the tax year but before filing the tax return

9. A general index of the principal and background documents and a description of the recordkeeping system

Documentation deadlines

Although documents are not required to be submitted along with the tax return, it needs to be in place at the time of filing the tax return. Under the US regulation for transfer pricing, the tax payer is required to submit the documentation within 30 days from the date of request made by the examiner.

Statute of limitations on transfer pricing assessments

The general limitation period applicable in US also applied in transfer pricing related issues, which is three years from the due date of return filing or from the actual date of return filing whichever is later. In case of substantial understatement of Income, the limitation is extended to six years and there is no statute of limitation applicable for fraud.

Return disclosures/related party disclosures

Various [128] returns/forms are required to be filed by the taxpayers. In accordance with the regulation issued in the fiscal year 2010, certain taxpayers are required to disclose their uncertain tax positions (UTPs) on Schedule UTP, and provide information such as the ranking of the positions by the sizes of their reserves, and brief descriptions of the tax positions. However, this disclosure norms are applicable only on the corporations with assets of $10 million or more.

[128] Forms 5471 and 5472 regarding transactions with related parties, and they may also need to file Form 8275(regarding disclosure) *available at* https://www.irs.gov/Tax-Professionals/Tax-Code,-Regulations-and-Official-Guidance (Last accessed on July 23, 2015)

Audit risk/transfer pricing scrutiny

Auditees are selected by IRS randomly, but the likelihood of an annual tax audit is dependent upon the presence of high risk transactions. Transfer pricing is extensively regulated in the US and the IRS has recently taken a number of administrative steps to increase its ability to focus on international transactions, generally with particular emphasis on transfer pricing.[129] In the backdrop, the intellectual property transactions have been designated as Tier I (high–risk transaction) issues. To strengthen its capability, IRS has created new positions like "Deputy Commissioner International" and a "Director of Transfer Pricing" and a significant number of transfer pricing professionals have been hired.

Although the likelihood of the Transfer Prices being challenged are quite high, the risk of penalty may be reduced with help of current and appropriate documents.

Advance Pricing Agreement opportunity

Rev. Proc. 2006–9 stipulates the norms for unilateral and bilateral APAs. IRS has established an APA program office and appointed competent authorities to deal with the respective issues. The revenue procedure prescribes strict procedures, disclosure requirements. Detailed guidance has been issued for taxpayers and the IRS for submission of APA requests and processing the same. Competent authority guidance is provided in Rev. Proc. 2006–54, which complements the requirements of Rev. Proc. 2006–9.

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[129] *Transfer Pricing,* FINANCIER WORLDWIDE (February 2015) ,available at http://www.financierworldwide.com/roundtable-transfer-pricing-feb2015/ (Last accessed on July 20, 2015)

China: Taxing authority and Tax Law

The Taxing authority in China is State Administration of Taxation (SAT). Tax Laws and regulations of China is People's Republic of China (China) Corporate Income Tax Law (CITL), Chapter 6, Articles 41 to 48 read with CITL Implementation Regulations, Articles 109 — 123. The regulations and rulings with regard to Transfer Pricing are available in:

1. Guoshuifa (2008) No. 114, (Guoshuifa 114)–Notice Containing Related Party Transaction Annual Reporting Forms;
2. Guoshuifa (2009) No. 2, (Guoshuifa 2)–Implementation Measures for Special Tax Adjustments;
3. Caishui (2008) No. 121, (Caishui 121)–Notice on the Tax Deductibility of Interest Expense Paid to Related Partie;
4. Guoshuihan (2009) No. 363, (Guoshuihan 363)–Notice on the Strengthening, the Monitoring and Investigation of Cross–border Related;
5. Guoshuihan (2009) No. 188, (Guoshuihan 188)–Notice on Intensifying the Transfer Pricing Follow–up Administration;
6. Guoshuihan (2010) No. 323, (Guoshuihan 323)–Notice on Guidance Given by SAT to Tax Bureaus with respect to Contemporaneous Documentation Reviews;
7. Guoshuihan (2011) No. 167 (Guoshuihan 167)–The Annual Anti–tax Avoidance Work Report which reports the 2010 anti–tax avoidance enforcement work conducted by SAT and the 2011 work plan,

OECD Guidelines treatment

The China Transfer Pricing rules and regulations are in line with principles and methods prescribed in OECD Transfer Pricing Guidelines (OECD

Guidelines) and the relevant transfer pricing methods prescribed by OECD.[130]

Priorities/pricing methods

Acceptable methods include CUP, Resale Price and Cost Plus. Other methods, including Profit Split, and Transactional Net Margin Method (TNMM). Operating margin and cost markup are mostly used for PLI. PLIs like return on assets or return on capital employed are not commonly used.

Transfer pricing penalties

Article 48 of the CITL prescribes some penal provisions for non-compliance of the prescribed regulations. In accordance with article 122 of the CITL implementation regulations, Interest at prevailing RMB lending rate + 5% interest charge is applicable on under-reported tax including transfer pricing adjustments. In accordance with article 106 of Guoshuifa 2, penal provisions are also applicable on taxpayers who failed to provide contemporaneous documentation. Pursuant to article 70 China Tax Collection and Administration Law and Article 96 of the China Tax Collection and Administration Law Implementation Regulations, as well as Article 44 of the CITL and Article 115 of the CITL Implementation Regulations penal provisions are applicable for filing false and/or incomplete related party reporting forms.

Penalty relief

Pursuant to Article 122 of the CITL Implementation Regulations, the additional 5% interest charge can be avoided if contemporaneous documentation are submitted within 20 days of a request.

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[130] *OECD Guidelines to Multinational Enterprises and Tax Administration* (OECD 2010)

Documentation requirements

The CITL and the CITL Implementation Regulations stipulates that taxpayers are expected to maintain contemporaneous transfer pricing documentation. The details with regard to contemporaneous documentation requirement is provided in Articles 13 through 20 of Guoshuifa 2. The primary components as listed below are provided in China's contemporaneous documentation Article 14 of Guoshuifa 2:

a) Organization structure
b) Information of business operations
c) Information of related party transactions
d) Comparability analysis
e) Selection and application of transfer pricing methods.

Article 15 states that certain enterprises can be exempted from the preparation, maintenance, and provision of contemporaneous documentation:

a) Those conducting RMB200m or fewer in annual related party purchase and sale transactions and RMB40m or fewer in annual related party "other" transactions (intangibles, services, and interest from financing transactions)
b) Those with transactions covered by an advance pricing arrangement (APA)
c) Those with a 50% or less share of foreign ownership that only conduct related party transactions within China

Documentation deadlines

According to Article 16 of Guoshuifa 2 the preparation of contemporaneous documentation should be completed on or before 31 May of the following

calendar year and that all documentation should be submitted to tax authorities within 20 days from the date of request.

Statute of limitations on transfer pricing assessments

In accordance with Article 20 of Guoshuifa 2, all contemporaneous Transfer Pricing documentation should be maintained for 10 years. The calculation of 10 years starts from 1st June of following year in which the transactions was entered.

Return Disclosures / Related Party Disclosures

Article 43 of the CITL and Guoshuifa 114 require that taxpayers complete and submit nine comprehensive 'Related Party Transaction Annual Reporting Forms' along with their annual tax filing.

Audit risk/transfer pricing scrutiny

The annual tax audit likelihood where transfer pricing issues are involved are quite high. Generally the transfer pricing methodologies are challenged by the tax authorities. In 2010, 178 transfer pricing audits were concluded. The resulting tax liability adjustment was RMB2.3b during 2010[131]. Additionally, the value of self–assessed anti–avoidance adjustments was even higher, reaching RMB7.2b in 2010. The risk of transfer pricing audit is quite high in case of the following scenarios:-

1. Ownership of local marketing intangible assets
2. Location savings
3. Business restructuring

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[131] *Transfer Pricing Global Reference Guide,* (E&Y, 2012) *available at* http://www.ey.com/GL/en/Services/Tax/International-Tax/Transfer-Pricing-and-Tax-Effective-Supply-Chain-Management/2012-Transfer-pricing-global-reference-guide---China (Last accessed on March 20, 2015)

It is argued by the tax authorities that Chinese distributors of multinational corporations (MNCs) own certain local marketing intangibles and therefore the value creation by the local companies are significant. This issue has resulted dispute between the authorities and the corporates with regard to comparable companies.

Another contentious issue is location savings where tax authorities often consider it to be non–routine contributions made by the Chinese manufacturers when selling products to overseas related parties. Since overseas entities earns profit by localizing the components in China, the contention of the authorities are that the Chinese Companies should earn more profit from these activities even if those companies do not own any intangibles and activities restricted to contract manufacturing.

Many MNCs have begun to transfer key functions to different locations within China, as tax incentives for its existing Chinese subsidiaries begin to expire[132]. As a result, tax authorities are placing higher scrutiny on business restructurings, especially those that result in significant drops in local profit levels. it has also been observed that as transfer pricing regulations become more mature and comprehensive in China, tax authorities will also tighten their enforcement of transfer pricing compliance and anti–avoidance investigations..

[132] *Transfer Pricing Global Reference Guide,* (E&Y, 2012) *available at* http://www.ey.com/GL/en/Services/Tax/International-Tax/Transfer-Pricing-and-Tax-Effective-Supply-Chain-Management/2012-Transfer-pricing-global-reference-guide---China (Last accessed on March 20, 2015)

APA opportunity

Advance pricing agreement opportunities are available in China. The guidance in this regard can be found in Articles 46 through 63 of Guoshuifa 2. In accordance with the regulation, the validity of an APA is between three and five years. Currently enterprises having operating history of less than 10 years or having a tax evasion history can also apply for APA. However, one of the precondition for applying to APA is that the annual transaction volume must be more than or equal to RMB40m, Applications for APAs involving more than one in–charge province can be submitted directly to the tax authority in Beijing.

On 30 December 2010, the SAT published the China Advance Transfer Pricing Arrangement Annual Report (2009) marking the first time China has published such a report on the APA program to an external readership. The report, covering the statistical data and analysis for the period between 2005 and 2009, mainly describes the rules and regulations, implementation procedures and practical development of China's unilateral, bilateral and multilateral APAs. Through its planned annual publication of the report going forward, the SAT hopes to achieve systematic administration of APAs, promote the use of APAs, and increase the transparency of the APA process. Finally, negotiation of bilateral APAs has become an increasingly effective tool in mitigating transfer pricing risks. Since 2009, there has been a continual decline in the number of unilateral cases with a sharp increase in bilateral cases[133].

[133] ibid

Malaysia: Taxing Authority and Tax Laws

The Taxing authority in Malaysia is Inland Revenue Board (IRB) and the tax law is Income Tax Act, 1967. Few general anti-avoidance provisions are provided in the following sections[134];

a) Section 140A of ITA stipulates provisions regarding power of taxation authorities to substitute the price and disallowance of interest on certain transactions,
b) Section 138C of ITA stipulates provision for Advance Pricing Arrangement
c) Section 140 of ITA authorize taxing authorities to disregard certain transactions if not deemed arm's length
d) Section 141 of ITA authorizes taxation authorities to evoke powers with regard to certain transactions entered by non–residents
e) The IRB rolled out the Malaysian Transfer Pricing Guidelines on 2 July 2003, which prescribes various regulation and procedures in this regard

OECD Guidelines treatment

OECD Transfer Pricing Guidelines are generally followed to frame the Malaysian Transfer Pricing Guidelines. The transfer pricing guideline of Malaysia prescribes that all transfer prices should be set at arm's length. which is the governing principle of any transfer pricing regulation.

Priorities/pricing methods

The IRB acknowledges CUP, Resale Price, Cost Plus, Profit Split and TNMM. However, the Malaysian Transfer Pricing Guidelines prescribes traditional methods as preferred method over the profit methods. It is advised

[134] http://www.hasil.gov.my/goindex.php?kump=5&skum=5&posi=3&unit=1&sequ=2 (Last accessed on October 10, 2015)

under the said regulation that the profit based methods should be used as last resort and should be used only when reliance cannot be placed on the traditional methods or traditional methods cannot be applied at all.

Transfer pricing penalties

Malaysian transfer pricing guidelines do not stipulates any specific penalties for non-compliance of the prescribed guidelines. However, the existing legislation and penalty structure under the ITA is applied for such non-compliance. Penalties for transfer pricing adjustments can range from 100% to 300% of the undercharged tax[135]. There is no specific transfer pricing documentation required to be submitted under Malaysian Transfer Pricing regulation.

Penalty relief

Although no specific documentation has been prescribed under Malaysian rule, An appeal for reduction in penalties can be made based on quality of contemporaneous transfer pricing documentation.

Documentation requirements

No documents are required to be submitted along with tax return, but should be made available to the IRB upon request. All relevant documentation must be in, or translated into, Bahasa Malaysia (the national language) or English. It is not required under the law that the taxpayer should disclose the availability of the documents at the time of filing return.

The IRB has set out a list of indicative information and documentation to be prepared for transfer pricing purposes. Since the list is not exhaustive and business specific, taxpayers are required to maintain information and documentation that are applicable to their circumstances. The list includes:

[135] Income Tax Act, 1967 § 114

a) Company Details
b) Ownership structure showing linkages between all entities within the MNE
c) Organisation chart of the Company
d) Operational aspects of the business including details of the functions performed
e) Transaction Details

Transaction details

Transaction details should include the list of transactions entered with the associated enterprise. The details should contain the name and address of the entity with whom the transactions were entered into, nature of transactions. The details should also contain the list of similar transactions entered with third parties or information obtained from third parties about such similar transactions.

Economic conditions during the time of the Transactions

Economic conditions include contractual agreements relevant for the transactions, any other indirect expenses like management fees, assistance fees, service fee, royalties etc paid to the respective entities. The economic condition to include:-

- Pricing policy over the past seven–year period;
- Breakdown of product manufacturing costs;
- Product price list;
- Determination of arm's length price: The pricing method adopted, showing how the arm's length price is derived, and indicating why that method is chosen over other methods;
- Functional analysis taking into consideration all risks assumed and assets employed.

While undertaking a comparability study, if the analysis results in a range of margin or prices, then all those outcomes should be submitted to the authorities with the reason for selection one out of those outcomes.

Documentation deadlines.

Although there are no deadline for submission of the documents prescribed under the law, since the documentation should be readily available upon request of IRB, it is advisable that the documentation should be completed before filing of return to make it contemporaneous.

Statute of limitations on transfer pricing assessments

There is a six–year statute of limitations for tax adjustments, and documentation must be kept for seven years[136]. There is no statute of limitations in instances of fraud, willful default or negligence.

Return disclosures/related party disclosures

Disclosure of arm's length values is required in the tax return for the following transactions:

1. Sales to related companies;
2. Purchases from related companies;
3. Other payments to related companies Lending to and borrowing from related companies;
4. Receipts from related companies

Issuance of Form MNE [1/2011] (Form MNE 2011)

The IRB has prescribed a form for compilation of below-mentioned information related to cross–border transactions for selected corporate taxpayers:

[136] Income tax Act, 1967 § 82A

1. Name(s) of related parties, both local and foreign;
2. A chart of the global corporate structure to which the taxpayer belongs, indicating the companies with whom the taxpayer conducts related party transactions.

Information on cross border intercompany transactions such as:

1. Sales/Purchases of finished goods/raw materials;
2. Management fees;
3. Research and development
4. Royalties/license fees and other payments on use of intangible assets;
5. Rent/lease of assets
6. Other services not falling under/any of the above categories

Particulars of financial assistance (showing balances during the year and the ending balance) with related companies outside Malaysia such as:

1. Description of the taxpayer's business activity
2. Distributor [Commissionaire/Limited Risk/Full Fledge]
3. Service provider
4. Manufacturing [Toll/Contract/Full Fledge]
5. Interest free loans;
6. Interest bearing loans;
7. Interest bearing trade credit;

Audit risk/transfer pricing scrutiny

Any Tax Audits which might cover transfer pricing audits also is conducted to cover a period of three to six years and hence the risk for the taxpayers are considered as medium. However, the risk for companies with related party transactions is high. The IRB have indicated via the Transfer Pricing Guidelines [137] that the traditional methods are preferred over the profit methods and advise that the profit methods should only be used when the traditional methods cannot be reliably applied or cannot be applied at all. Accordingly, if a profits–based method is applied without substantiation, the risk of the methodology being challenged is high.

APA opportunity

Section 138C of ITA stipulates the norms for unilateral and bilateral APAs in Malaysia.. The authorities have established a specific unit in the IRB to oversee the APA applications and negotiations.

[137] Chapter 2 was inserted in Income Tax Act, 1967 with regard to procedures and guidelines on Controlled Companies and powers to protect the revenue in certain kind of transactions.

United Kingdom: Taxing authority and tax law

The Taxing authority in UK is Her Majesty's Revenue and Customs (HMRC). It publishes its internal guidance for tax payers and their advisers with insight into how HMRC applies on the Transfer Pricing legislation. HMRC also publishes technical notes and Statements of Practice concerning a number of transfer pricing topics.

Tax law

The UK's transfer pricing legislation is set out in Part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). This covers cross-border and domestic transactions. The UK does not have a process for transfer pricing outside of an Advance Pricing Agreement (APA).

OECD Guidelines treatment

UK Transfer Pricing guidelines are based on the OECD Transfer Pricing Guidelines (OECD Guidelines) with some adaptation for the country. UK has framed a revised transfer pricing policy in Finance Act 2011 which is based on the 2010 Version of the OECD Guidelines. In accordance with §164 TIOPA 2010, UK's transfer pricing provisions are in alignment with Article 9 of the OECD Model Tax Convention and its associated transfer pricing guidelines. Currently, as noted above, the 2010 version of OECD guideline is required to be used for accounting periods ending on or after 1 April 2011, while the 1998 version applies to earlier periods. Notwithstanding the above, OECD committees are actively represented by the HMRC. In effect it is endeavor of HMRC to adopt the most recent OECD guidance for double taxation agreements that are based on the OECD Model Convention.

Priorities/pricing methods

The OECD Guidelines are followed with regard to pricing methods. However, post 2010, HMRC challenges the robustness of external CUP data ,particularly in relation to IP licenses

Transfer pricing penalties

Schedule 24 of the Finance Act 2007 prescribes the penal provision for negligence. These provisions stipulates the provision for negligence or deliberate omission which results into non-compliance. The penalties are prescribed at 100% of the tax amount. However, where there is a loss after the adjustment, the penalty is restricted to 10% of the loss adjustment. HMRC has recently published revised scenarios of negligence/carelessness which carry lower penalties which is restricted upto maximum penalty of 30 percent. However any deliberate inaccuracies attracts a maximum penalty of 70 percent.

Examples of negligence and carelessness include:

1. No attempt to price the transaction;
2. Shared service centre overseas, cost base, allocation key applied — turnover, modest mark up, but no consideration of benefits test for UK entity;
3. Policy, otherwise arm's length, not properly applied in practice

Examples of deliberate inaccuracies include:

1. A clear internal CUP has been omitted with no reasonable technical analysis to support why it has been disregarded;
2. A cost plus return to a company that has in reality controlled the development of valuable intangibles (as not demonstrable as a sub–contractor to group members)

3. Material factual inaccuracies in the functional analysis on which the pricing analysis has been based

Penalty relief

The taxpayer can sought relief from penal provision if it can demonstrate that it has taken due care and diligence to comply with the regulation. However to do so, the taxpayer should maintain proper documentation which should be able to fully demonstrate that the transfer price was set at arm's length.

Documentation requirements

HMRC's internal guidance sets out the indicative list of documents that a taxpayer should be able to submit on request. OECD model was followed to roll out this list. The UK guidance prescribes documentation into primary accounting records, tax adjustment records and, most importantly, evidence. HMRC prescribes some suggested documents, which should demonstrate the application of arm's length principle while setting the transfer prices, such as:

1. An identification of the associated enterprises with whom the transaction is made
2. A description of the nature of the business
3. The contractual or other understandings between the parties
4. A description of the method used to establish or test the arm's length result, with an explanation of why the method is chosen

HMRC also prescribes that the documents should contain an explanation about the commercial and management strategies, forecasts for the business or technological environment, competitive conditions and regulatory framework HMRC shifts the burden of proving the correctness of the transfer price and application of arm's length principle on the taxpayer and expects

that the documentation should be able to demonstrate convincingly the reason for the tax losses.

Documentation deadlines

The documents are expected to be in possession during tax return filing. This regulation ensure that the documents are contemporaneous.

Statute of limitations on transfer pricing assessments

Under the UK Law, the assessments can be undertaken within 4 years from the end of the relevant financial years. However, no such statute of limitation is applicable in case of negligence and the assessment can be completed within 20 years for a willful misstatement. This specific regulation is applicable when the error was not fully disclosed in the tax return.

Return disclosures/related party disclosures

There are no specific disclosure requirements for related party transactions except as required for annual reports and statutory accounts. However, in absence of any specific requirements, the taxation authorities may open the prior years under discovery assessments to form a view about the application of arm's length principle with regard to transfer pricing.

Russia: Taxing Authority and Tax Law[138]

Taxing authority: The Federal Tax Service of the Russian Federation (FTS)

Tax law: Federal Law No. 227–FZ, effective from 1 January 2012 (Law 227)[139]

Relevant regulations and rulings

Law 227 prescribes specific transaction which should be liable for compliance of this regulation. The law focuses on the related party transactions and includes only certain types of third–party transactions. In relation to cross–border transactions, the following will be subject to transfer pricing control:

a) ***All related party cross border transactions without any threshold limit are subject to transfer pricing regulations***
b) **Third Party Transactions**

   i) Third–party transactions involving goods traded on global commodity exchanges and value of transactions exceeds RUB60m are subject to transfer pricing regulations.

   ii) In case unrelated parties are located in some specific jurisdiction, the transactions are subject to the purview of the regulation if the transaction exceeds RUB60M.

c) Related party domestic transactions are subject to transfer pricing regulation if the transaction value exceeds RUB60m and the related parties enters into following transactions:
   1. The subject of the transaction is an object of assessment to mineral extraction tax calculated at an ad valorem tax rate;

[138] *Available at* http://www.russian-tax-code.com/ (Last accessed on July 10, 2015)
[139] *Available at* http://www.cms-russia.info/transfer-pricing/cms_tax_connect_flash_russia.pdf (Last accessed on July 10, 2015)

2. One of the parties to the controlled transaction is exempt from paying profit tax, or pays the tax at the 0% rate;
3. One of the parties to the controlled transaction is registered in a special economic zone (such transactions will be controlled from in 2014).

For all other domestic related party transactions, the transfer pricing regulation will be applicable if the transaction value exceeds RUB3b. However, the provision will not be applicable if the below-mentioned criteria are met :

1. Both parties are registered within the same region of Russia.
2. None of the parties have economically autonomous subdivisions in other regions of Russia nor pay income tax to the budgets of other regions;
3. None of the parties have tax losses, and
4. There are no other grounds for the transaction to be controlled (same criteria which are applicable for the RUB60m threshold outlined above)

Related parties

The transfer pricing law has defined the Companies and individuals who can be treated as related party for this purpose. However, the main criteria remain as ownership threshold for being considered as related party. The law stipulates that if one party directly or indirectly controls more than 25 percent of another party, then both the parties will be treated as "related" for this purpose. However, courts can declare companies and/or individuals to be related on any other grounds, if one of the party can influence the decision of the other party.

OECD Guidelines treatment

Although Russia is not a member of OECD, new transfer pricing law is significantly based on the principles stipulated in the OECD guidelines.

Priorities/pricing methods

Comparable Uncontrolled Price method, Resale Price Method, Cost Plus method, TNMM, Profit Split Method has been prescribed under the law as appropriate method for transfer pricing purpose. However, the CUP method is considered to be priority method, whereas the Profit Split has been prescribed as last resort. Under the law the taxpayer can select any other appropriate method which demonstrates the application of arm's length principle

Transfer pricing penalties

The law stipulates a penalty of 20% till 2017 and after which, the penalties will be increased to 40 percent[140].

Penalty relief

Penalties will be imposed if a taxpayer's income is adjusted as a result of a transfer pricing audit, and if the taxpayer did not provide the requested transfer pricing documentation. Penalties cannot apply if prices were established in accordance with an applicable advance pricing agreement.

Documentation requirements

The law prescribes maintenance of suitable and appropriate document to prove the application of arm's length principle. The law does not prescribe any standard form for documentation, however, it envisage that the

[140] *Available at* http://www.cms-russia.info/transfer-pricing/cms_tax_connect_flash_russia.pdf (Last accessed on July 10, 2015)

documentation should be able to justify the pricing method used in controlled transactions where the annual revenue of all controlled transactions between the same related parties exceeds RUB100m.

Documentation deadlines

The Taxpayer is required to submit the documents within 30 days of the tax examiner's request. However it also stipulates that the request for documentation cannot be issues earlier than1 June of the year following the year in which the controlled transaction took place.

Statute of limitations on transfer pricing assessments

The tax authority may audit the taxpayer for up to the three years preceding the year when the audit is conducted.

Return disclosures/related party disclosures

The Law prescribes some disclosure norms for the transactions which are subject to transfer pricing regulation, which should include third party transactions also.

Audit risk/transfer pricing scrutiny

The likelihood of annual tax audit is high. It can be also expected that the transfer pricing methodologies adopted will be challenged during the course of Audit. However, the approach of the taxing authorities are unknown since the applicability of the regulation is only effective from 2012 onwards.

APA opportunity

The APA program is available from 1 January 2012 and only for "large taxpayers." A non–Russian company cannot apply for an APA.

CONCLUDING THOUGHTS

From the literature study of Transfer Pricing regulations of major countries, it is observed that countries have now formulated detailed rules and regulations to regulate transfer pricing abuse. The documentation and transfer pricing methodologies are mostly based on the OECD guidelines. In some cases the documentation are not standard. Also the methodologies and documentation requirement are indicative and not specific to the business, which leads to ambiguity. It is also observed that the onus of proving the appropriateness and correctness of transfer price is shifted to the taxpayers. In general the arm's length principle governs the basic regulation. However, the process of proving the correctness of application of the basic principle if quite complex and dependent on interpretation of respective parties. There is no specific approach suggested in any of the guidelines about what should be the approach for a specific business model. For example, it would have been more clear for the taxpayer, if the regulations could stipulates a preferred method based on business model. It is also observed that due to numerous documents prescribed under the statute, the documentation and other related costs has increased for MNCs.