

CHAPTER 7

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PART A-ISSUES

One sided Transfer pricing methodologies adopted for calculation of arm's length pricing

It is observed by the researcher that in general a one sided methodology is generally used by Companies in formulating a global transfer pricing policy. The policy is also further influenced by the transfer pricing law of the country where majority of its business is carried on. For example, in the case of a US based manufacturing company, companies will generally deploy Cost-Plus methodology²⁵⁹ as appropriate methodology for deriving arm's length pricing. The Cost-Plus model is always acceptable by the revenue authorities in case the mark-up²⁶⁰ (or "plus") is acceptable by them²⁶¹. The issue arises for a global company with business presence in different tax jurisdiction, with such one sided methodology, due to transfer pricing challenges faced by them in the country where goods or services are received. For example, Company X manufactures goods in USA and sells it to an associated company Y located in India. Company X adopted Cost Plus methodology as transfer price for the goods sold in India. Based on the comparability study, Company X derived 13% as markup on the goods sold to India. Therefore for a particular component, in case the cost is calculated as \$ 100, US entity sells the goods to Indian AE at \$ 113. The competitors of Company Y in India sells the same component but locally manufactured to customers in same business segment. The competitors of Company Y are not exposed to²⁶²Fx volatility risk since they manufacture and procure goods locally. In these circumstances, Company Y, which is mainly a

²⁵⁹ See page 37

²⁶⁰ Mark-up is the difference between the selling price and cost of goods and services sold

²⁶¹ GAP International Sourcing (India) Pvt. Ltd. vs ACIT Circle (12), New Delhi [2012]149TTJ(Delhi)437

²⁶² Fx Volatility risk referred to the risk borne by a Company during settlement of a import bill due to volatile currency of the host country

trader of the goods manufactured by Company X, is compelled to sell at the prevailing market price which is say INR 7500 per component. Company Y had to incur say 15% as customs duty and other incidental charges, freight to bring the goods to its warehouse (Landing factor). Also it incurs another 3% as selling and general administrative cost in India. Thus the total cost for Indian entity Y will be $\$113 + 18\%$ of $\$113 = \134 . The payment to Company X was made by Company Y in US\$ as per global rule. Therefore, the Fx risk borne by Company Y. The exchange rate for conversion is INR 62/- per US\$. Therefore the cost of the component in India will be INR 8267. Since the selling price was INR 7500, the Indian Company will sustain a loss of INR 767 per unit whereas the US entity will earn \$13 per component. Therefore on a global level, the group will be earning a positive margin and will be able to recover the cost at least. However, taken separately the Indian entity will sustain loss and US entity will earn profit. In the above scenario the disparity of taxable Income is evident when one sided methodology is adopted. Due to the above reason, cost plus methodology is considered as one-sided.

Issues with regard to meeting the taxation objective

The researcher has observed that currently Transfer Pricing policy is adopted by a Group to meet the taxation objectives²⁶³ which should be ideally market driven. However, the researcher has also observed that even if a Group adopts a transfer pricing policy to meet taxation objectives, in many cases the objective is not attained. In the example given above, the US entity was earning \$13 on

²⁶³ Taxation objective of a Company includes optimum tax management to reduce tax risk and reduce the effective tax rate for the Company

which the entity was liable to Corporate Tax up to 40%²⁶⁴ in the US. The table appended below shows the consolidated tax liability of the group:-

Table 31: Consolidated Tax Liability

In INR

Particulars	In US Books	In India Books	Consolidated
Income	7006	7500	7500
Cost	6200	7006	6200
Value Addition		1261	1261
Profit Before Tax	806	-767	39
Tax @ 40%	322	Deferred Tax @ 33% 253 ²⁶⁵	69
Profit after Tax	484	-514	-30

The above table revealed that although group earned a Profit before Tax, it has sustained losses after tax. Tax liability was the main reason for sustaining loss, after tax since the effective tax rate was more than 100%. The effective tax rate is expected to be lower than 100% if the tax planning is optimum. It is observed by the researcher that the effective tax rate for the group is more than 100% in that case mainly due to inaccurate transfer pricing policy. Additionally it is observed that although the tax expenses in the consolidated books is calculated as INR 69, the actual tax payment in US was INR 322. The tax liability in the consolidated books is net of deferred tax income of Indian books, the recoverability of which is dependent upon future profitability of the Indian entity.

²⁶⁴ Federal tax rates in USA on corporate taxable income vary from 15% to 40%. State and local taxes and rules vary by jurisdiction.

²⁶⁵ Deferred Tax as per Management Book and US Book

From the above table it is observed that the Group has failed to reduce its tax liability due to improper transfer pricing.

The Group needs to review the possibility of utilising the deferred tax income recorded in the Indian books against its future tax liability. The losses sustained in India were not a result of initial set up cost or high cost due to penetration into the new markets. It was observed that the losses were sustained in India mainly due to improper business decisions like not localizing the products which resulted into loss of market share due to high import cost. Since the Company lost its share of business in India market mainly due to price disadvantage which will not be automatically recovered.

Economic challenges due to one sided method

The above example shows the business and economic challenges²⁶⁶ which companies may face due to adoption of improper Transfer Pricing policy. Some of them are indicated below:-

- a) In today's globalized environment customers are not only exploring cost-out opportunities²⁶⁷ through re-engineering²⁶⁸, but re-sourcing²⁶⁹ is one of the other ways to achieve cost out.

- b) In a competitive environment and in e-Commerce²⁷⁰ regime, the prices and other commercial terms for selling goods and services prevailing in

²⁶⁶ Economic challenges in relation to a Company refers to economic scale of operation, profitability and return to shareholders

²⁶⁷ Cost-out mean reduction of cost per unit of production

²⁶⁸ Re-engineering of a product is undertaken to increase the performance of a product and/or reduction in cost through improvement in production process or change in design and material used

²⁶⁹ Re-sourcing mean optimizing the cost through correct selection of supplier

one country can be compared in other country and in case is economical, the customers may purchase from any country where the product will be cheaper.

- c) In the example given above²⁷¹, the prices of Indian competitors are competitive and therefore the information will not only be restricted in India but the customers located overseas will also explore to replace their existing supplier
- d) Continuous loss sustained by a subsidiary in host²⁷² country may create a negative impression about the sustainability and profitability of that unit amongst the business managers and decision makers of the group. Due to doubts about sustainability of the unit, all investments might be suspended which will create apprehension amongst the employees of the local unit resulting in high employee turnover²⁷³. In case of high employee turnover, a company incurs additional expenses like cost of training, recruitment besides being not able to retain knowledge.
- e) Due to continuous losses sustained by the local unit, the business managers will try to optimize SG&A²⁷⁴ cost through restructuring program which may result into deterioration of customer service

²⁷⁰ Electronic commerce commonly known as eCommerce, is trading in products or services using internet

²⁷¹ see Table 19 at p.229

²⁷² Host country refers to the country where the subsidiary is operating

²⁷³ Employee turnover in human resource context means replacing an employee with another employee

²⁷⁴ SG&A is Selling, General and Administrative expenses of a business unit

capability²⁷⁵ of the local unit due to reduction in workforce and high employee turnover. Any deterioration of service capability will result into drop in market share and loss of share of business with its valued customers.

- f) Any further reduction in volume due to loss in market share will increase the loss for the local unit since the company will not achieve economies of scale. This will result into increase of cost of goods and services to be sold. Additionally, cost for the products and services will increase due to local unit not operating at economies of scale²⁷⁶. Due to increase in cost, to improve the profitability of the unit, the unit will increase their selling price. This pricing strategy will further reduce the market share due to stiff pricing competition in the local market. The group will continue to hold the investment and continue to reduce the workforce as part of their restructuring program since the unit will not be able to generate profit due to the reasons mentioned herein. This will lead to reduction in organisation capability to serve the customer as per their need.
- g) Any such action mentioned in point no. f) above will result in continuous loss in market share and any future initiative to regain the market share by the company in host country will not be considered as credible and sustainable by the customer.
- h) The above actions will result into dissolution or suspension of operation in the host country. The information of such action in host country will not be

²⁷⁵ Customer service capability includes quoting for products and services, after sales service, warranty support

²⁷⁶ The reduction in per unit cost of production due to expansion is known as economies of scale

restricted to that market or country only due to free access of information. This kind of information will reduce the credibility and sustainability of the group elsewhere also which may impact negatively on the brand image²⁷⁷ globally.

- i) The above issue will result into either hiving off²⁷⁸ the business unit or suspension of operation globally

Challenges in documentation

One of the major challenges in Transfer Pricing is documentation. The challenge is faced by both the selling entity and receiving entity of any products and services, if both these entities are situated in different tax jurisdiction²⁷⁹. The challenges in documentation for Corporates are observed in various court rulings²⁸⁰.

In the example given in Table 22²⁸¹, the challenges with regard to documentation and providing proof of selecting appropriate methodology for deriving arm's length pricing lies on both the Indian entity and US entity. The challenges for the US entity with regard to documentation and proving the appropriateness of arm's length pricing are as below:-

²⁷⁷ Brand image refers to the impression in customer's mind about brand's real and imaginary qualities and shortcoming.

²⁷⁸ Hiving off means split of the small unit from a big company to either sale or suspend operation

²⁷⁹ An area, city, municipality, country with its own distinct regulations for taxation

²⁸⁰ see table 1 at p.4

²⁸¹ see p.242

- a) If the products sold to associated enterprises are exclusive or semi-finished components then it is unlikely that the comparable sales price of any uncontrolled entity will be available.
- b) The mark-up²⁸² added to the cost needs to be compared with an unrelated party transaction based on the functional analysis of the transactions and the risk borne by the Company.
- c) It will be hard to demonstrate that all the relevant costs are allocated to this transaction, in case standard costing methodology²⁸³ is adopted in lieu of actual costing methodology²⁸⁴ or where no costing records need to be maintained.

The challenges for the Indian entity will be as below:-

- a) The Indian entity needs to prove the arm's length pricing for the transaction entered into with the Associated Enterprise. The first issue for the Indian entity will be to select an appropriate methodology for the pricing arrangement²⁸⁵.
- b) The Cost Plus method²⁸⁶ adopted by the selling entity will not be acceptable to the Indian Tax Authority as the best method for arm's length pricing since cost plus model is one sided methodology as described in earlier section of the study.
- c) Since the Indian entity was working as a distributor for the US entity, the Resale Price methodology²⁸⁷ will be most appropriate methodology for

²⁸² see p. 47

²⁸³ Standard Costing system methodology refers to an estimated or predetermined cost of performing an operation of production of goods

²⁸⁴ Actual costing refers to costing methodology where actual cost of products or services are ascertained

²⁸⁵ Alfa Laval (I) Ltd vs DCIT [2014]149ITD285(Pune)

²⁸⁶ see p.47

²⁸⁷ see p.43

calculation of arm's length pricing. However, since the sales price was derived by adopting cost plus method, application of resale price methodology will not be possible for Indian entity.

- d) The justification for loss incurred by the entity in India²⁸⁸ cannot be attributed to only market penetration pricing policy²⁸⁹ since the company failed to cover the variable cost²⁹⁰ also from the sale of the product.
- e) A comparable uncontrolled purchase price for products purchased from associated enterprise will not be available with the Indian entity since the selling entity has an exclusive distribution agreement with the Indian entity. Also the researcher has observed that in most cases a price list is not published by selling entities which could be used as a comparable price list in the given example and can be produced as internal comparable.

Alignment with Indirect Tax and other statutes required

The alignment of Transfer Pricing policy adopted by the Group²⁹¹ with other Indirect Tax Act, especially Customs Act, is very important. The Transfer Pricing policy should be formulated keeping in mind the impact on other statutes. If transfer price for the goods sold is too low or the transfer pricing policy does not conform to the Customs Act of the country where purchasing entity is located, it could create an additional liability for the group as a whole²⁹². The Customs authority relies on an arm's length pricing principle and would like to satisfy that the selling entity can recover the cost over a period of time by recovering correct

²⁸⁸ In this example, it will be the Indian entity

²⁸⁹ Market Penetration pricing policy is adopted by a Company to enter into a new market or with a new product

²⁹⁰ A cost which varies with production volume

²⁹¹ Group refers to the Multinational Group

²⁹² See chapter 5 of this study

prices from the purchasing entity. In case Transfer Price is low, although it may be acceptable to the Income Tax Authorities, the same may not be acceptable to the customs authority²⁹³. In case of a low transfer pricing, the customs authority will not accept the pricing or transactional value as basis for taxation since the same will reduce the duty. Also in case of any retrospective adjustment of transfer pricing through "True-up" or "True-down"²⁹⁴ in case of a cost plus model, the pay-out can change the basis for duty paid earlier. Thus, any subsequent pay-out can increase the liability in form of interest and penalty as per the Customs rules of the country where the purchasing entity is located.

Improper Transfer pricing can have an impact on Excise Duty²⁹⁵ liability for the local unit also. In case of FIAT Automobile vs Union of India²⁹⁶, the apex court ruled in favour of the department and observed that the Company was liable to pay duty on the cost of manufacturing since the selling price to its distributors was lower than the cost of manufacturing. We will consider an example as below to elaborate the issue in detail:-

Company "X" in India works as an assembly & testing center for a global Automobile Company. Company "X" purchases all the components from its AEs which charges Company "X" for those components by adopting cost plus model. As per Transfer pricing policy adopted by the group, the mark-up is charged

²⁹³ The objective of the Customs Authority is to ensure that appropriate duty is paid on imported goods. If the transfer pricing is low, then Customer Authority may apprehend that such transfer price is set to avoid customs duty.

²⁹⁴ In cost plus model, a periodic adjustment is done to recover actual cost, which is known as true-up or down as the case may be.

²⁹⁵ Excise duty is levied on Manufacturing of goods. Hence if the selling price to a distributor (who is considered as related party) is lower than cost of manufacturing, the selling price may not be accepted as basis for excise duty calculation, in accordance with § 4 of The Central Excise Act 1944.

²⁹⁶ Commissioner of Central Excise, Mumbai v M/s Fiat India Pvt. Ltd & Anr [2012] TIOL-58-SC-CX

over and above the cost of the source plant. In India Company "X" sustains losses since the price charged to its distributors for the finished products are lower than cost of components purchased from AE, landing factors²⁹⁷ along with labour and burden charges in India. The excise duty was calculated on sales price. Since the cost was higher than the prices charged to distributors for the finished goods, the excise department may not accept the transaction value as the basis for charging excise duty since distributors are related party as per section 4 of The Central Excise Act 1944. Hence the component cost should be priced by adopting a correct pricing policy.

Transfer pricing can also have an impact on Competition law²⁹⁸ in the host country. Any lower pricing for penetration in the market of the host country can be construed as "Predatory Pricing"²⁹⁹.

In accordance with the new Companies Act 2013, members eligible u/s 244 of the said Act, are eligible to file complaint to tribunal to prevent oppression or mismanagement³⁰⁰. Thus, in case a Company adopts an aggressive transfer pricing policy to transfer profit from one entity to other entity to avoid distribution of dividend to minority shareholders, based on a complaint file by eligible

²⁹⁷ Landing Factors include Customs Duty, Freight Paid to bring the Material into the factory and other local taxes like Octroi Duty etc.

²⁹⁸ Competition Law is different in different countries. These Laws are enacted to ensure a fair competition in market place. In India the competition law is governed by Competition Act, 2002.

²⁹⁹ Predatory pricing is occurs when a firm sells a goods and services at a price below cost. Predatory pricing is illegal under anti-trust laws or competition act.

³⁰⁰ s.241(1) Any member who complaints that:-

(a) the affairs of the company have been or are being conducted in a manner prejudicial to public interest or in a manner prejudicial or oppressive to him or any other members or in a prejudicial to the interest of the company

may apply to the Tribunal, provided such member has a right to apply u/s 244, for an order under this chapter.

members as per s.244 of the Companies Act, 2013, Tribunal may pass an order to prevent such mismanagement and oppression to the minority shareholders.

Burden of Proof

With the significant increase in overseas transactions and between related parties, transfer pricing has become an important daily activities for global enterprises. Considering the trade deficits and revenue collection pressure for development of the host countries, revenue authorities has become quite skeptical about scope for tax evasion. Continuous prejudice use of the word “Transfer Pricing” has become almost synonymous to “Tax evasion” in most of the countries. Corporates are facing severe challenges during tax assessments in every host countries. It is also true that Corporates are in position to diverge funds from high tax countries to low tax countries by setting improper transfer prices. In absence of an absolute rule for transfer pricing documentation and arm’s length principle, the revenue authorities finds Transfer pricing related issues as opportunities to increase revenue collection. The situation has worsened with increased scrutiny of transfer pricing and stringent rules at some of the developed countries. The developing countries like India to secure its revenue has also formulated lot of new procedures and rules for transfer pricing management³⁰¹. The revenue authorities to avoid any miss from their end have started disputing every transaction³⁰². This has resulted into disagreements between revenue authorities and corporates about taxable income reported in every jurisdiction. Although tax treaties³⁰³ are available and dispute resolution

³⁰¹ Statutory framework to curb Transfer Pricing abuse was enacted through § 92 to 92F of Income Tax Act, 1961

³⁰² See Table at p.4

³⁰³ Tax Treaties with contracting nation are available through Double Taxation Avoidance Agreements (DTAA)

mechanism³⁰⁴ exists amongst most of major trading nations, the reality is that the transfer pricing disputes are time consuming and huge litigation costs are involved. In most of the cases, it is observed by the researcher that the first level authorities do not agree with the transfer pricing mechanism adopted by the Corporates and therefore a huge tax amount with penalties are imposed. This has resulted into double taxation in some cases and in other cases the matters are being referred to tribunal for solution, which is increasing the litigation cost for the corporates as well as exchequer.

It is further observed by the researcher that the onus of proving the appropriateness and correctness of arm's length price derived for any related party transaction lies on the taxpayer himself³⁰⁵. The taxpayer during the audit proceeding is responsible to prove to the assessing officer about 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 officer may pass an adjustment order including penalty and interest in accordance with the provisions of the Income Tax Act, which would increase the taxpayer's liability.

The researcher finds that compulsion of independent pricing can create scope for the corporation to create a competitive environment internally within the organisation which would lead to improvement in efficiency. Through a proper independent and uncontrolled pricing process, the multinational enterprises can

³⁰⁴ Alternative Dispute Resolution mechanism is available through Mutual Agreement Procedures (MAP)

³⁰⁵ Rule 10A to 10E of Income Tax Rules, 1962

achieve the economic objectives³⁰⁶ and also will be able to add value to the shareholders wealth by properly allocating the scarce resources to the performing locations only. This tool can be used also for proper evaluation of the respective units which have a significant positive impact on morale of the employees and performance of the unit.

Issues with selection of methodology

Most of the countries while formulating a detailed transfer pricing policy have enumerated the principles of deriving and calculating acceptable arm's length pricing. These countries while formulating the transfer pricing framework, whether or not a member country of OECD³⁰⁷, have adopted the methodology recommended by OECD for calculation of arm's length pricing. However these methodologies can be only adopted in case proper documentation and appropriate comparables are available.

In most of the cases, the researcher has observed that a multinational enterprise adopts a Transfer Pricing policy which adheres to the Transfer Pricing rules of the country where the selling organisation is located and the rules and regulation of the Customs Act of the country where purchasing organisation is located. This process results into adoption of Transfer Pricing Policy which can be termed as one-sided methodology³⁰⁸ in establishing arm's length pricing.

³⁰⁶ see p.240

³⁰⁷ Organisation for Economic Co-operation and Development

³⁰⁸ Cost-Plus methodology is one of such methodology which adheres to the Transfer Pricing rules of the country where selling organisation is located since cost-plus methodology ensures that the selling organisation earns a comparable profit. The same methodology also ensures that it adheres to the valuation rules of the Customs Act of the country where the purchasing organisation is located, since cost-plus methodology ensures that the seller recovers the cost of production.

The one-sided methodology as explained above creates a challenge for the purchasing unit to prove the adoption of the appropriate arm's length pricing. The difficulty increases due to some other complex nature of transactions with the associated enterprises such as use of shared service centers, cost allocation from headquarters, royalty payment for use of "Trademark" and business system, use of common IT infrastructure and payment thereof, use of common facility and common cost allocation for the same. Amongst all of the above issues, the researcher finds that the cost allocation from headquarters which are termed as "Shareholder Service"³⁰⁹ is the most contentious issue in transfer pricing.

As is evident from the above, selection of a correct transfer pricing methodology for group is not very easy. In absence of all requisite documents and information, generally TNMM methodology³¹⁰ is adopted. The researcher has observed that to avoid adopting transaction based approach which requires a detailed costing, database maintenance and comparability analysis, the Companies and the Transfer Pricing consultants generally adopts TNMM methodology. However, grouping of transactions considering the functionality and risk and reward concept is not followed on most occasions and therefore the arm's length pricing process and audit process become more contentious. This issue results in dispute in numerous transfer pricing assessments³¹¹.

Few issues with selection of TNMM methodology can be listed as below:-

³⁰⁹ See p.293

³¹⁰ See p.64

³¹¹ See Table at p.4

- a) Adoption of Entrepreneurship approach vs transaction based approach may lead to ignorance of the risk and reward concept³¹²
- b) Activities like Toll Manufacturing³¹³, contract manufacturing and full-fledged manufacturing are considered same for comparability purpose in absence of full information
- c) Adjustments for Asset employed and risk assumed is generally not done for comparison with an unrelated party transaction.
- d) Value addition³¹⁴ of the product by each entity involved in the value chain are not considered for comparison
- e) Economies of scale³¹⁵ and start-up costs are not considered
- f) The researcher further observed that separate independent legal entity approach is adopted by a group for the purpose of statutory reporting only and not for the actual functioning.

Permanent establishment issue

As per provision of Section 9 of the Income Tax Act, 1961 a permanent establishment is any fixed place of business in India for an overseas enterprise.

³¹² Risk and reward concept in arm's length pricing context mean that reward should be different based on the risk assumed by each entity

³¹³ Arrangement where company will process raw materials or semi-finished goods for another company is called Toll Manufacturing.

³¹⁴ Value addition of a final product is done at various stage of production. In current situation, the researcher has observed that various internal units are involved in the value addition process.

³¹⁵ The reduction in per unit cost of production due to expansion is known as economies of scale

There are various transactions which are covered under the provision of section 9 which can be treated as an activity carried on by a permanent establishment. Article 5 of the OECD Model Tax Convention describes these various conditions under which A Permanent Establishment may exist. OECD has also issued a guideline under Article 7 about the application of arm's length principle in case a permanent establishment exists.

In accordance with paragraph 2 of Article 7 of OECD, where an enterprise of a Contracting State carries on business in other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profit which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.³¹⁶

Article 5 defines a dependent agent PE to an enterprise exist where a person, other than an agent of independent status, is acting on behalf of an enterprise and has habitually exercises, in a Contracting State, an authority to conclude contracts in name of the enterprise³¹⁷.

We will use an example below (which the researcher has observed during his study) to elaborate the situation in detail:

Company "S2" was an associated enterprise of Company "S1" in Switzerland. Company S2 was engaged in selling and distribution of lifts and escalators in India manufactured by "S1". Company "S2" does not have any manufacturing

³¹⁶ Extracted from OECD Model Tax Convention

³¹⁷ Article 5, OECD Model Tax Convention

facility in India. The entire contract with the customer would be negotiated and concluded by Company "S2" in India. The customers were instructed to import the materials directly from Switzerland against a Letter of Credit opened by the customer in favour of S1. The reason for doing the same is to facilitate the customers to avail all the import related benefits and to avoid recording the related party transaction in the books of S2 and thereby avoiding applicability of the transfer pricing provisions.

Prima facie the transactions listed above appeared to be compliant with laws. However when the above transactions are analysed by the researcher in detail, the following points were revealed, which would create S2 as a permanent establishment of S1 in accordance with article 5 of the OECD and Double Taxation Avoidance Agreement between India and Switzerland read with section 9 of the Income Tax Act, 1961.

- I. The prices settled with the customer by S2 was a composite price and artificially broken down into two parts viz., a) Cost of Components which are directly paid to the overseas AE (S1) by the customer and b) Price for installation and commissioning to be paid by the customer to S2. The word "artificial" should be noted here since the price breakdown would be driven by the cost of components quoted by S1 which includes profit for S1 and not based on actual cost for both the entities.

- II. Entire logistics supports to customers for transporting the material from the source plant of S1 to the customer premises are provided by the Indian entity and the cost for which would be borne by S2

- III. The pricing breakdown would lead to losses for the local entity (S2) in most of cases where the price competition with the competitor was stiff, beside the future cost of service during warranty period.
- IV. The Indian entity (S2) would provide all service including cost of failed component, if any, free of cost to the customer during warranty period.

The above business model would lead the Indian entity to become a permanent establishment of the overseas entity and therefore the enterprise would be subject to tax in host country.

A separate legal entity analysis is required to develop understanding of the terms and conditions that governs the functions performed by different controlled parties to a particular transaction. The researcher has observed that in some cases, although the assets are legally owned by one entity but the other party takes decision about the utilization of those assets. Apparently the transfer pricing analyst of the group and the taxing authorities of the host country need to perform a detailed functional analysis to uncover the entity which owns the assets legally and the entity which controls those assets for a proper attribution of profit between both the enterprises.

The following example which the researcher observed during his study will help to elaborate the situation:-

Company "X" has a factory in India which was acquired under a deal. The factory used to produce 3 product line and used to supply various companies including the competitor of the current company. After acquisition, the factory became a contract manufacturer of the overseas entity. All the decisions used to be taken by the overseas enterprise including volume, product line and

management decisions. The factory used to stop the production to facilitate full production in US factory.

These conditions of the business can lead the factory in host country becoming a permanent establishment of the overseas entity.

In this situation there are no contracts available for the transfer pricing analyst and the taxing authority to decide the applicability of the Permanent Establishment. The analyst and taxing authority must review the “contractual terms” by reviewing “accounting records”, together with the internal documents, purporting to transfer risks, responsibilities and benefits from part of the enterprise to another part³¹⁸.

To avoid double taxation³¹⁹, the business conditions needs to be scrutinized in detail and any such transactions as mentioned in above two examples should be reviewed in detail and modus operandi needs to be changed, if required.

Current hypothesis and penalty & Interest – Cash Outflow issue

Due to the complex nature of the cross border³²⁰ inter-unit transactions entered by a multinational organisation, the current hypothesis is that a multinational enterprise is in a position to transfer profits through manipulative transfer pricing from a high tax jurisdiction country to a low tax jurisdiction country to minimize the taxation impact and thereby increasing the shareholders return. Another reason for resorting to an artificial and manipulative transfer pricing device is to consolidate the cash in the country from where shareholder’s dividend will be

³¹⁸ Reports on the Attribution of Profits to Permanent Establishments Part I(General Considerations), II (Banks) and III (Global Trading), 214, p.55

³¹⁹ Double taxation can arise when an enterprise pays tax for a single transaction in more than one country

³²⁰ Cross border transactions are entered by two unit located at different tax jurisdiction

distributed³²¹. In many countries like India, repatriation of Income is not easy and tax is imposed on distribution of dividend. Therefore, a multinational enterprise can set up a manipulative pricing or charge some exorbitant service charges which can be mostly termed as "Shareholders services"³²² as an allocation of headquarter cost. These are aimed to transfer the surplus cash out of the country to improve the cash flow of the entity located in the country from where the dividend will be distributed to the shareholders.

The researcher has also observed during this study that in recent years, the developed countries³²³ has established very stringent norms with regard to transfer pricing policies and also enunciated stringent penalties and interest for violation of any such provisions. It is further observed that adoption of one-sided transfer pricing policy by US multinationals results into reduction in the collection of the taxes in the host countries.

The stringent norms of the transfer pricing by the developed countries like USA have led to establishing one sided transfer pricing policies by the entities doing business from US. Cost Plus model is one of such model which is accepted as the best applicable method in USA. It has led to various debates in other countries specifically OECD member countries. In response to Cost plus method of US, OECD has recommended TNMM as an alternate methodology for its member countries.

³²¹ The researcher observed that in host country unit is fully owned by another unit of the same multinational group and in most of the occasion the group is listed in some other country. Hence, the dividend is distributed from a different country than the host country where dividend distribution tax may be also applicable.

³²² see p.293

³²³ The criteria for evaluating the degree of economic development for classification of "Developed" and "Developing" nation are Gross Domestic Product (GDP), Gross National Product (GNP), Per Capita Income, level of Industrialisation etc.

Due to above reasons, transfer pricing authorities have become skeptical about any intra-group transactions and consequently majority of transactions are disputed by the Taxing Authorities in host countries and huge demand of Tax due is levied to difference in calculation of arm's length pricing by the authorities and by the Companies³²⁴. Even though the Company has legal remedies against any such impugned orders passed by the lower assessing authorities, those remedies are time consuming and expensive and therefore sometime not viable option. Further in accordance with appeal procedures rules and regulations, companies may need to pay a certain portion of the tax demanded as pre-deposit before appeal can be filed with the appellate authorities. The payment of deposit before the appeal results into cash outflow and blockage of precious working capital³²⁵.

Shareholder service charges

Shareholder services refer to those services where the fee charged by the related companies for the services rendered by the related parties cannot be considered as service for the benefit of service recipient. The situation arises when the services rendered by the service providers mainly cater to the requirement of the shareholders for controlling the activities of the local unit. These types of services are considered as "shareholders services". Generally

³²⁴ For statistics on dispute see table at p.4

³²⁵ In one of instance, the researcher observed from the balance sheet of one of the Company selected for empirical study that the Company has paid a significant amount as deposit for the appeal, since in last 7 years every transfer pricing assessment had ended up in a dispute and therefore the company had to appeal to the appellate authorities by paying a certain percentage of the demanded differential tax as deposit. On further scrutiny it was observed that approx. 20% of the net working capital was blocked as pre-deposit paid as a condition for the appeal. This significant amount will be treated as Nonperforming assets and therefore return on capital employed (ROCE) will be impacted for the Company.

allocation from corporate headquarter as support charges can be considered as shareholders service in absence of any detail of service received.

In most of the cases it is found by the researcher that entity where the group headquarter was located or the entity where the regional headquarter was located raises an invoice on the entity located in the host country for "Support Service". It is also to be noted in the light of the fact that since professionals and competent persons are employed by the unit in host country, there are no justifications for the invoices raised by the group for support service which include services like support for finance, IT, marketing etc³²⁶. Also it is quite difficult for the companies in host countries to prove the receipt of such services. It was further observed by the researcher that generally there are no comparisons available for prices paid for such services. These charges are always contested by assessing officers on the following grounds despite the fact that decisions or business prudence is prerogative of the taxpayer:-

- a) Justification for the services received
- b) Proof of the services received
- c) Benefits derived from such services
- d) Comparability of the prices charges for such services

Industries or Transactions of special importance

In accordance with Transfer Pricing regulations prevailing currently, there are no industries or transactions which can be excluded from a possibility of detailed transfer pricing scrutiny. Hence the Companies are required to maintain a

³²⁶ It was observed in one of the instance by the researcher that the support service charges paid to group was almost to the tune of 50% of the total administrative cost incurred by the unit in host country

detailed transfer pricing documentation which will help them to prove the appropriateness of the arm's length pricing during assessment proceedings. Although Safe harbour rule³²⁷ provides some relief to the specific industries fulfilling the norms from transfer pricing scrutiny, there are some inherent shortcomings which lead to an apprehension about the applicability of the rule in Indian context. The criteria of adopting safe harbour rule are in some cases quite stringent to achieve. Some of these criteria are:

- a) Only block of 5 years at choice of the assessee is available for adoption of safe harbour rule. Therefore, any subsequent adoption of safe harbour rule is not available to the assessee. The researcher has observed that the local units are not always sustaining losses due to initial start-up costs and hence earning profits in subsequent years is dependent upon appropriate business restructuring and change in pricing models.
- b) The high range of profits required to be earned by respective industries³²⁸ for adoption of safe harbour rule are sometime not achievable.

Specific situations are also scrutinized in detail by the transfer pricing authorities. Some of such situations are listed as below:-

- a) Sustaining continuous losses by an unit in host country
- b) Business Model with PE risks
- c) Business restructuring initiated by any Company
- d) Transactions with entities in tax heaven countries

³²⁷ See p.106

³²⁸ as specified in the said rule

- e) Payment of Royalty
- f) Management Charges and regional allocation of cost

Thin Capitalisation

Thin capitalization³²⁹ refers to a situation where the debt-equity ratio of a Company is not comparable with the industry standard. This is perceived to create a problem with revenue authorities, who are concerned about abuse by an entity through excessive interest deduction. Also the researcher has observed that in most of the cases the loan is extended by an internal unit of the group. At this point of time, there are no such provisions which disallow a company to select certain debt-equity ratio in India. But with the introduction of Direct Tax code in India, the government may propose to introduce Thin Capitalisation provision. Thin Capitalisation provision has been already rolled out in various countries. This is another area which multinational companies should appropriately comply with. Although interest paid by a company to its AE is subject to arm's length pricing, the debt-equity ratio can form a methodology to transfer profits from high effective tax rate entity to low tax rate entity³³⁰. Although the proposed regulation will not prescribe any capital gearing ratio, but debt equity ratio can be scrutinized in terms of business prudence and commercial substance.

Limitation of double taxation and competent authority proceedings

With the increasing disputes with regards to Transfer Pricing issues, the Government of India has set up a competent authority under Mutual Agreement Procedures (MAP) which serves as an alternate dispute resolution mechanism.

³²⁹ A Company is said to be thinly capitalized when its capital is made up of a much greater proportion of debt than equity

³³⁰ The researcher has observed that in many cases a unit enjoying Tax Holidays in India is extending loans to a unit which is a tax paying entity. Due to high interest paid by such entity the effective tax rate has become "nil" in most cases.

The Corporates have started using MAP processes effectively where the tax disputes are significant due to transfer pricing and/or PE³³¹ related matters.

Most of Indian tax treaties under bilateral agreements with other countries provide that in case of associated enterprises, the tax charged by one country would be able to be set-off in the other country. However, to facilitate such a process, acceptability of revenue authorities of both the countries are important. In such a scenario MAP process³³² is important. This route can be invoked by the corporates along with other available alternate domestic dispute resolution mechanism. The Government of India has signed MoU with the competent authorities of UK and USA to facilitate MAP. One of the key features of the MoU is that the revenue authorities will suspend collection of tax till the settlement of the matter which is acceptable to both the country. However a bank guarantee needs to be provided to facilitate such process³³³. The Companies need to use their credit limits available with their bankers for issuance of such bank guarantees. Such usage of credit limit or cash will be non-productive for the Company.

Payment for Intangibles

Valuation of any intangibles and to prove correctness of arm's length pricing is always contentious. Additionally any payment for intangibles which is not part of the prices paid for goods and services calls for additional scrutiny from the Customs Authorities. The researcher has observed that Transfer Pricing Officer would like to satisfy himself that Company has derived quantifiable benefits by

³³¹ Permanent Establishment

³³² The MAP article in tax conventions allows designated representative (the "Competent Authorities") from the governments of the contracting state to interact with the intent to resolve international tax disputes. These disputes involve cases of double taxation (juridical and economic) as well as interpretation and application of a convention. Source OECD.Org

³³³ To facilitate such process till resolution, the companies are required to submit a Bank Guarantee equivalent to tax demand with the Competent Authority.

use of intangibles like any business systems, Trademarks etc. for which royalty is paid to any related party³³⁴. Customs Authorities also satisfies themselves that in form of Royalty, Company has not paid any amount in addition to the amount originally paid to the related party while importing the goods. This is done to ensure that appropriate customs duty was paid on the imported goods. Few contentious issues for royalty payment against use of trademark are listed below:-

- a) The use of Trademark and benefits derived from such use needs to be proved to Transfer Pricing Officers
- b) The basis on which royalty was calculated
- c) Documentary evidence showing that benefits were derived from use of any such intangibles

Part B - Recommendations

Recommendation to the Corporates

Companies should adopt country centric and transaction based Transfer Pricing policies. A thumb rule approach may lead to serious litigations worldwide. The

³³⁴ In one of the cases it was found that the Company was paying royalty on the "Business System" developed by the group company for standardization of business process. At the same time the regional offices were also charging support cost. The TPO disputed both the charges holding the view that charges were being paid for the same activity twice although the royalty was paid for use of Business System which was a copyright product of the entity located in US and the services charges were paid for day-to-day support.

limitation of one-sided Transfer Pricing policy like Cost Plus method is discussed in earlier section of this study.³³⁵

Companies should adopt methodologies based on their existing business model and which are acceptable in the host country.³³⁶

Companies should adopt Transfer Pricing policy, which adheres to the rules of the other statutes in the host country³³⁷. Any improper transfer pricing may lead to litigations with customs authorities too³³⁸.

In this context the researcher submits that any improper transfer price will not only increase the litigation with Transfer Pricing Authorities, it may also face oppression or mismanagement charges from minority shareholders³³⁹ since they will lose their value of shares due to continuous losses sustained by the Company arising from improper Transfer Pricing and due to which these shareholders may not earn adequate dividend.

To avoid uncertainty about future taxation exposure, all proposed transactions should be scrutinized proactively for functional analysis and adequate

³³⁵ See p.47

³³⁶ For example, in case a Company follows Cost plus model, and applies this mode to every transaction, then this can lead to serious litigation in purchasing country. Also as mentioned in the Economic objective Chapter of this study, the inequality of profit sharing between units will lead to employee dissatisfaction resulting into higher cost of nonconformance including waste and scrap. A unilateral methodology would allow cost centers to inflate their costs in absence of any control on cost or target profit which would ultimately lead to non-viability of the product and/or services.

³³⁷ For detailed analysis of Transfer Pricing impact on other status see page no 165

³³⁸ For impact on other Statutes see Page 165

³³⁹ Thus, in case a Company adopts an aggressive transfer pricing policy to transfer profit from one entity to other entity to avoid distribution of dividend to minority shareholders, based on a complaint file by eligible members as per s.244 of the Companies Act, 2013, Tribunal may pass an order to prevent such mismanagement and oppression to the minority shareholders.

documentation should be created to justify the business prudence and price comparison.³⁴⁰

The researcher submits that the units should be independent to negotiate the price of services offered by internal units of the group. In case the prices of internal service providers are high, the Companies should be free to decide about awarding the assignment to any third party agencies³⁴¹. In the event there are no third party agencies available for providing such services and thus the prices levied by the internal unit are not comparable, documentation should be prepared to substantiate the rationale for engaging internal unit in lieu of third party. Further comparability of the commercial terms of the agreement with the internal unit should be done besides price comparison.

The transfer pricing policies should be carefully adopted after a proper study of the worldwide business model of the group. Additionally the following aspects should be considered while adopting a transfer pricing policy:-

a) Adoption of appropriate Transfer pricing policy for each transaction should not be reactive but proactive

³⁴⁰ Any subsequent adjustment for the prices paid earlier for any sales of goods may violate the rules of the Customs Act prevailing in the country where purchasing unit is incorporated and therefore penalty and interest may be levied on such transactions

³⁴¹ § 188 of the Companies Act, 2013 puts an obligation on the Companies (Private and Public) to obtain prior approval of Board or Shareholders (if Share Capital is more than 10 crore), before entering into specified contracts with related party. However, if the transactions are entered into by the Company in normal course of business or at "Arm's Length Price", then the provision of this section will not be applicable. The researcher has observed certain limitations in the provision. In case a Company perceives that the transactions are entered into by the Company in normal course or at arm's length price, then no prior approval is required. In case Company feels that the transactions are not at arm's length price, the Company will either set the price correct or provide evidence that the transaction was at arm's length price. Otherwise, the Company needs to bear additional tax liability.

As a matter of practice, the researcher has noted that in most of the cases Companies design and document justification for arm's length pricing after a transaction is completed³⁴². Transfer pricing policy for a multinational enterprise is generally adopted keeping in mind the rules and regulation of the country where the maximum business is carried on. It is recommended that the Companies should adopt a policy considering business models and Transfer Pricing and allied policies prevailing in all countries where this group is doing business. Typically activities are grouped by multinational enterprises as below for transfer pricing documentation purpose:-

- a. Manufacturing
- b. Service
- c. Distribution
- d. Sale of Intangibles

However the above classifications of activities are too general in nature. The functionalities and other important factors cannot be identified from the above classification. Therefore, the activities mentioned above should be further sub-divided for understanding their functions, risk borne by each entity, value additional done at each level

In case of a manufacturing industry, the activities may be further subdivided as below:-

³⁴² In case a Group adopts a Cost-Plus methodology for calculating Transfer Price of products sold from all its selling units, the receiving units of that group will be forced to adopt a reactive transfer pricing policy. The researcher has observed that receiving unit generally resort to adopting contentious TNMM methodology to prove the appropriateness of arm's length pricing

- a. Manufacturer of Finished goods
- b. Manufacturer of Semi-finished goods
- c. Contract Manufacturing
- d. Toll Manufacturing

In case of Service sector, the activities may be further sub-divided as below:-

- a. Shared Service without creation of intangibles
- b. Service provided for creation of intangibles
- c. Service extended for supporting or establishing business
- d. Knowledge sharing

In case of Distribution business, the activities can be further sub-divided as below:-

- i. Stock and Sale Model
- ii. Agency Model

b) The Transfer pricing policy should not be one sided

A one-sided transfer pricing policy³⁴³ should not be adopted unless completely unavoidable. The limitation of a one-sided methodology has been discussed in earlier section³⁴⁴. This study also revealed the necessity of detailed understanding of business model and thereafter adopting a transfer pricing methodology which should be acceptable to all

³⁴³ Like Cost Plus Methodology. For details see p.47

³⁴⁴ See p.47

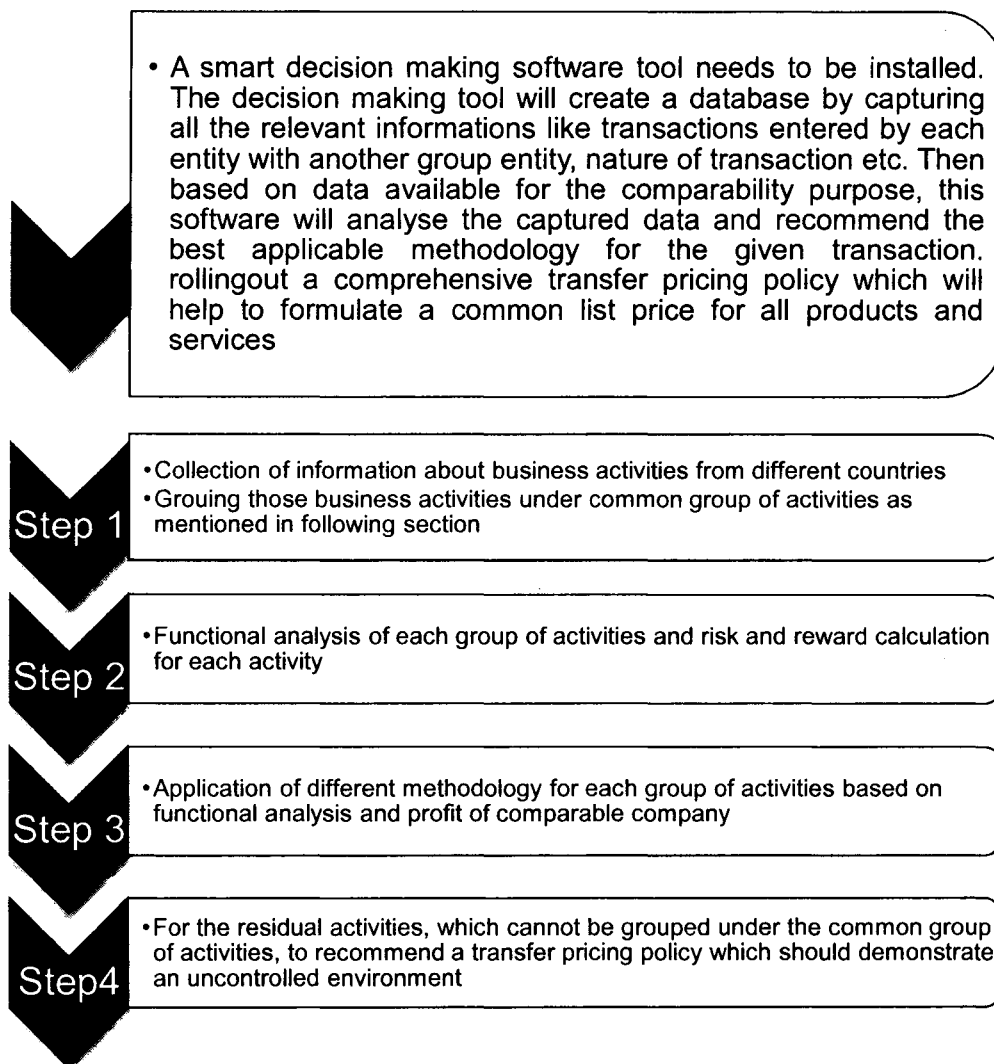
the stakeholders³⁴⁵. Otherwise adoption of any one sided methodology, which has some inherent limitations³⁴⁶, will result into disputes. Also Companies should adopt transfer pricing policy for each segment of business and if possible, for each group of business separately.³⁴⁷

- c) **Process** : The researcher recommends that Companies should adopt a transfer pricing policy after following the steps indicated below:-

³⁴⁵ See chapter 6

³⁴⁶ See chapter 6

³⁴⁷ Company E has manufacturing units in various countries and each of the manufacturing unit produces some products which are produced exclusively for the associated enterprise as semi-finished product. Different regional manufacturing centers were established for increasing on-time delivery and inventory reduction, as per latest manufacturing roadmap prepared by the group. In this situation, adoption of a transfer pricing policy for the group as a whole will not be simple. As discussed earlier, Cost Plus methodology will be one-sided and will be acceptable to the Transfer Pricing Authority of the Country where the selling unit is located but may not be acceptable for the Transfer Pricing Authorities of the country where the purchasing unit is located. In absence of any alternatives or comparables, the purchasing entity will adopt TNMM methodology with a entrepreneurship approach to justify the arm's length pricing .



The following table summarizes the recommended grouping of activities and preference for adoption of Transfer Pricing methods³⁴⁸:-

²⁰⁷More than one preferred methodologies has been prescribed since the appropriate methodology selection dependent upon availability of documents. The best suited

Table 32: Grouping of Activities and Preferences for adoption of Transfer Pricing

Transactions	Methods				
	Comparable Uncontrolled Price Method	Resale Price Method	Cost Plus Method	Transactional Net Margin Method	Profit Split Method
Payment of Interest	√				
Distribution of goods**	√	√			
Provision of Service excluding management charges	√		√		
Contract Manufacturing**	√		√		
Manufacturing**	√		√	√	
Payment of Royalty	√				
Transactions for manufacturing involving intangibles	√				√

methodology in different circumstances and based on the availability of documents is discussed in subsequent section.

Management Charges	Cost plus method is applicable since without proof of service the charges will be disallowed.
Sale of Shares, intangibles	No Specific method, Independent valuation report can be relied upon

- Payment of Interest: Comparable Uncontrolled Price Method (CUP) is prescribed as the best suited methodology for payment of interest to an associated enterprise. Payment of Interest should be segregated from any other complex transaction and for separately this transaction Comparable Uncontrolled Price should be the best and appropriate methodology for proving the arm's length pricing. The appropriate information for comparison of interest rate would be Prime Lending Rate of the main Bank. Any interest to be paid to associated enterprise should be compared with the PLR of main Bank of the Country in which it is paid. However in case of a overseas lender, PLR of the paying country may not be acceptable to the authorities of the receiving country. Therefore LIBOR can be treated as the information for comparison purpose. The same methodology would be applicable for Interest on Long term Loan, Short Term loan, Bond , ECB and any other instrument through which the loan was obtained from associated enterprise. However there are certain other factors which needs to be considered before the rate of interest can be finalised or compared. The interest rate of a Bank for extending loan depends upon factors like business case and future earning capability of the lende,*

*collateral security provided, information to be submitted, credit appraisal of the lendee etc . All these factors and documents also needs to be completed and validated before PLR or LIBOR is considered as appropriate comparable. The adjustments, if any, for important factors which are not prevailing in case of loans provided by associated enterprise needs to be done before the rate of Interest is finalised.*³⁴⁹

³⁴⁹ Generally loans extended by an Associated Enterprise to it's group company does require any collateral security. In such case Prime Lending Rate (PLR) of main Bank will not be comparable. The risk factor for not having such security should be added to the PLR. In case PLR of SBI is say 11% and the risk factor calculated for not providing such security is say 2%. Then the comparable rate for the Loan would be 13% and not 11%.

Full Fledged Manufacturing and Distribution (With Inventory, receivable and market risk)

<p style="text-align: center;"><u>Applicability of CUP and Documents required</u></p> <p>In case of distribution activity by one of associated enterprises situation in a different tax jurisdiction than the enterprise manufacturing the finished goods within the same multinational group, then the CUP is applicable. In this case internal CUP will be applicable. The group should instruct all its manufacturing plants to publish a price list for all its finished goods which will be sold as such through its uncontrolled distributors and as well as for associated enterprise appointed as distributors. The common price list should be acting as a document for internal CUP. It is to be kept in mind that all conditions for a distributors like agreement, deposits if applicable, payment terms, warranty support and all other conditions should be same. No separate charges for intangibles should be applicable here</p>	<p style="text-align: center;"><u>Applicability of Resale price Methodology and documentation required thereof</u></p> <p>In case no internal CUP is not available to apply CUP methodology for this transaction, then the Company should apply Resale Price Method which is most applicable method in this situation. For resale price maintenance methodology, the group company should first collate all information about probable business volume from each country. Then it should collate the average margin for a distributor of the respective Country. Each Manufacturing location should prepare their price list and discount should be given each Associated Enterprise acting as a distributor for that manufacturing location. Discount rate will be dependent upon the expected margin to be earned by the distributor in that country. However as a documentation, the margin earned by respective distributors will need to be produced by the manufacturing location to its authorities. In this context, there can be contest between the manufacturing location and distributors about whether to sell or not at the given price in case discount results into loss for the manufacturing location.</p>
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Contract Manufacturing

Contract Manufacturing with exclusive capacity commitment

Contract Manufacturing are those arrangement where the purchaser provides all technical guidance and the finished products are mainly manufactured by some other manufacturer including but not limited to the purchaser itself. In this case the manufacturer are supposed to manufacture as per design and volume ordered by the purchaser. The seller does not assume market risk and in most cases volume risk also. Since there is no volume risk assumed by the seller, the appropriate model is considered to be Cost Plus Model. In this case cost means all cost (Direct and Indirect). The documents required to be maintained are details of cost + comparability of the mark-up for the selling company, whereas for purchasing company the documents will be comparative quotes for the products from unrelated parties. For all purchasing company purchasing materials and components for value addition, the process of documentation the process for purchase should be followed and comparable quotation should be procured for comparability purpose

Contract Manufacturing without exclusive capacity commitment

In this case since the manufacturer has not committed any capacity, he is free to utilise his capacity for other customers. Hence a comparability is available in form of Internal CUP. Hence the same should be used for comparability purpose. In case the same capacity is not utilised for any unrelated parties, then the same business process would be tantamount to contract manufacturing with capacity blocked for related party. The business analysis and investment decision should be scrutinised to further analyse whether the capacity is eligible to be used for other purpose. The corporate governance will also be scrutinised to understand whether there is a controlled decision of not utilising the same capacity for other purpose. In the case answer is affirmative, then the same would be considered as capacity commitment for the related party and all the processes and documents mentioned in that segment would apply. For purchasing company in either situation, the process mentioned in the other section would be applicable.

Service

Service Provider

Service provider should price their products based on either cost plus model or any other comparable model. For example, comparable hourly rate should be ideal for any kind of service provision. In case of engineering service, testing service, installation service, an hourly rate should be calculated which should ensure recovery of full cost. In this case it is needed to be kept in mind that pricing for provision of service dependent upon whether the capacity is blocked for the service receipt or not. In case certain capacity is blocked for a particular service receipt then all the cost pertaining to that capacity should be recovered by an appropriate pricing process. Similarly in case of any specialised services like Accounting, Taxation, marketing support etc, the costing should be done a comparable pricing strategy should be prepared. In this case, it should be noted that a pricing strategy needs to be prepared based on the functions performed and therefore any uniform pricing strategy should be avoided

Service Receipt

For a service recipient any service receipt from Associated Enterprises should be done after careful consideration of the belowmentioned facts:-

- a) Justification for the service need should be prepared. In any circumstances services should not be compulsory from the group but for necessity and value addition
- b) Comparable quotations for other service providers need to be obtained for comparability purpose. Otherwise a bid-waiver form with proper justification for such service needs to be prepared in line with normal business processes.
- c) Proof of service receipt should be preserved for submission as evidence during the assessment procedure

In case the nature of the service provided by the associated enterprise is unique in nature and no comparable is available for the prices charged by the associated enterprise, then charges for similar service may be compared or a comparability analysis from an external source may be procured.

Recommendation to the Direct Tax Authorities

The researcher observed that the sole purpose of Transfer Pricing always may not be aimed at transferring profit out of the host country. However, due to complex nature of transactions, shifting of profit may be done through indirect means³⁵⁰.

After introduction of domestic transfer pricing rules by the Government of India, it is important for the Transfer Pricing officers to understand the group structure and presence of associated Companies in India and nature of transactions entered within these Companies³⁵¹. The Transfer Pricing Assessment officers should also consider the facts that transferring of profit from an entity liable to pay tax to an entity enjoying tax holidays can be also done through an indirect way or by cost sharing by an associated enterprises without any benefit being accrued to recipient company³⁵².

It is recommended that a Transfer Pricing Officer should assess the appropriateness of arm's length pricing by adopting the prescribed steps as below:-

- i. All the transactions entered into by the Company under scrutiny, should be grouped as mentioned in above section³⁵³ to remove the complexities of the inter-group transactions and to enable the Transfer Pricing

³⁵⁰ Providing Marketing support service for the group in host country without earning any commission for such marketing activity. This will reduce the taxable income of the unit located in host country, since the cost of supporting such marketing activities are recorded in the books of accounts of the unit located in host country without any compensating income for such expenses.

³⁵¹ This is important since profit can be also shifted from a tax paying entity to an entity of the same group which is enjoying tax holidays.

³⁵² As explained in "Shareholder Service Charges" section

³⁵³ See table 32

Officers(hereinafter referred to as TPO) to develop understanding of the business model of the assessee to uncover the actual functionalities of all the transactions.

- ii. The TPOs should also analyse whether the assessee is operating as a separate entity where the business decisions are independent. If this is important to ensure that the conduct of the assessee should be consistent with the economic substance of any transaction.
- iii. Generally non availability of documents and comparable information is one of the justifications given by the taxpayers for not adopting CUP³⁵⁴. However, the documentations mentioned in the above section ³⁵⁵ are easily available and hence those should be demanded. In case appropriate documentations are not provided by the assessee, existing penal provisions for not keeping proper documents can be invoked.
- iv. Since functional analysis and Business model analysis will help to reveal applicability Permanent Establishment provisions under section 9 of the Income Tax Act, It is important for the TPOs to analyse all the transactions in light of the said section and recommend further scrutiny for the applicability of the said section to the Assessing Officers, since domestic transactions (excluding specified domestic transactions) are excluded from the purview of Transfer Pricing assessments. The TPOs

³⁵⁴ Comparable uncontrolled Price Method. For details see p.37

³⁵⁵ See documentations mentioned under various methodologies

should be verifying whether the key decisions of the assessee are influenced or controlled³⁵⁶.

- v. It is recommended that Assessing officer should scrutinize some unrelated specific domestic transactions also if the business model of the assessee is complex in nature. The assessing officer should especially scrutinize the details of the expenses incurred by a Company under a turn-key project, jointly executed by an associated Company.³⁵⁷
- vi. Although business prudence is the prerogative of the assessee, any decisions resulting into continuous losses should be scrutinized to assess whether any indirect benefit is being transferred by this decision. The AO should scrutinize the expenses to understand that whether decision to incur such expenses, which is resulting into continuous losses, should be considered as expenses incurred in normal course of business and can be considered as allowable business expenditure.³⁵⁸

³⁵⁶ For example, if, after acquisition, a certain productline is stopped in local country which is resulting into underutilization of the Plant and ultimately loss is sustained by the entity in host country, it is important to analyse the applicability of § 9 of the Income Tax Act, 1961.

³⁵⁷ For example, warranty claim borne by local Company, when material was supplied by overseas Company, or, installation cost is more than earning, when the contract is a turnkey contract and material is supplied from overseas.

³⁵⁸ Although in different court rulings, loss on account of foreign exchange rate fluctuation is considered as an allowable expenses, if a Company has not entered a hedging agreement due to internal decision, and sustained significant exchange loss during the year, the decision should be scrutinized in detail for applicability of 40(A)(2), since in normal circumstances, a Company would enter into hedging contracts in case the same company is exposed to Foreign Currency volatility³⁵⁸. The researcher observed in one instance that one of the group Company was tax paying unit in India, stopped entering into Fx hedge contracts since the other unit of the group Company was enjoying tax holidays in India and was a net exporter. The group achieved the hedging objective on an overall basis, although the tax paying unit started sustaining loss in India.

- vii. Besides Statutory and Audited Books as per Indian GAAP³⁵⁹, TPOs should also scrutinize the management books³⁶⁰ since lot of expenses are only considered in statutory books and not considered for performance measurement. These expenses should be scrutinized in detail for allow ability as business expenditure³⁶¹.
- viii. TPO/AO should scrutinize in detail the service charges and cost paid to shared services center to identify "Shareholder Service Charges"³⁶² and applicability of section 40(A)(2) of the Income Tax Act, 1961.
- ix. For payment made to Associated Enterprises for services received, it is very important to scrutinise the following:-
1. Nature of service and their justification and relevance with the current business
 2. Existence of Price Comparison with unrelated party
 3. Proof of the Service receipt/benefit received

Recommendation to the Government

Increasing litigation³⁶³ with regard to Transfer pricing is impacting the business confidence index³⁶⁴ of India since all Corporates wants a stable taxation policy

³⁵⁹ GAAP refers to Generally Accepted Accounting Principles, a standard framework of guidelines for financial accounting. On 16th February 2015, the Ministry of Corporate Affairs (MCA) notified the Companies (Indian Accounting Standards) Rules, 2015.

³⁶⁰ Management Books refers to the internal reporting system which is used to analyse the performance of the unit

³⁶¹ Refer "Shareholder Service Charges"

³⁶² The shareholder services are a method of diverting the cash from the country

³⁶³ *Infra*

³⁶⁴ Business Confidence Index is published by World Bank every quarter for each country

³⁶⁵and no future taxation uncertainties and prolonged litigations are appreciated by any Company. Also the entire transfer pricing assessment processes are currently based on trial and error method which in corporate world is termed as "Upward delegation"³⁶⁶. In this situation the litigation cost of the Government and Corporates are increasing³⁶⁷ besides creating a non-conducive environment for business. The current initiative like "Make-in-India"³⁶⁸ can be impacted due to tax litigations and uncertainties in future. Government of India has mentioned that it would like to remove the "Tax –terrorism"³⁶⁹ to create the conducive environment for business. On the contrary, comment of the Finance minister of India that "India is not a Tax Heaven"³⁷⁰ has to be understood in that context. On the other hand, for the growth of the country and to provide sufficient employment, a conducive environment for FDI has to be created³⁷¹. For a balanced approach, my recommendation to the Government would be to formulate a separate taxation policy for transfer pricing which should include the following:-

- i. Safe harbour policy to be announced for all start-up Companies for at least 3 years from the commencement of business where no Transfer Pricing Audit will be ordered even if there is a loss. The AO will conclude the Audit based

³⁶⁵ Refer article published in "Business Standard", Dated

³⁶⁶ In maximum cases the matters are not getting resolved at assessment level and being referred to Tribunal.

³⁶⁷ Approximately 0.4% of GDP has been spent by Government of India on litigation management (source CNBC). Transfer pricing dispute can cost a Company from a range between 1-2% of the tax demand.

³⁶⁸ Make-In-India initiative was Launched by Prime Minister of India in the year 2014 for promotion of India make goods

³⁶⁹ Tax-Terrorism is defined as skepticism and over pro-activeness of the taxation department leading to litigation, penalty etc.

³⁷⁰ BUSINESS STANDARD (April 10, 2015)

³⁷¹ Infra

on TP report and Accountant report³⁷² submitted by the assessee and self-assessment of arm's length pricing of the Company

- ii. The threshold for scrutiny assessment to be based on percentage of purchase from Associated Enterprise in lieu of current threshold of absolute value of 5 crore as per internal guidelines issued by the Income Tax department
- iii. The researcher also of the opinion that after 3 years of initial start-up period, in case a Company continue to sustain losses, a minimum alternate tax of 20% on Gross Profit less third party service cost as "India Business Tax" should be levied on all those companies where related party transaction constitute more than 50% of the total cost and the Company would like to pay such taxes in lieu of detailed scrutiny³⁷³. This will support a stable tax system without future uncertainties.³⁷⁴

³⁷² See, Income Tax Rules, 1961 Rule 10A

³⁷³ A cost benefits analysis by the revenue authorities should be done to evaluate the proposal. Alternate Tax rate of 20% is calculated based on the detailed analysis and the probability analysis of the corporates agreeing to the proposal.

³⁷⁴ The researcher observed that due to complex nature of transactions between associated enterprises, maintaining separate database and transfer pricing administration cost for the Companies are increasing. Also the litigation costs are increasing due to contentious issue of arm's length pricing.

- iv. It is recommended that guidelines and rules to bring Thin Capitalisation³⁷⁵ under the purview of taxation should be issued.
- v. Taxes on shareholders service³⁷⁶ to be introduced for all related party transaction and DTAA³⁷⁷ should be amended appropriately for tax credit in host country for such taxes paid in India, in case safe-harbour rule as proposed in point number (iii) above is not adopted by the Companies
- vi. It is recommended that the appellate process should be amended to introduce mandatory deposit of 25% by the Companies against the Tax demand to reduce litigation at Tribunal level³⁷⁸. A similar amendment is made recently for Central Excise appellate process.
- vii. A speedy trial process to be ensured to dispose of the cases at tribunal level.
- viii. MAP³⁷⁹ process to be strengthened to ensure proper disposal of all such referrals in time

³⁷⁵ *Infra*

³⁷⁶ See definition of "Shareholder Services",

³⁷⁷ Double Taxation Avoidance Agreements(DTAA) are bi-lateral agreements entered into with different countries to provide double taxation relief to a taxpayer.

³⁷⁸ *Infra*

³⁷⁹ For definition and procedure, please refer Key Concept Section of this study.

- ix. Secretarial Audit³⁸⁰ (even for a Private Limited Company) having transaction of 50% or more with related party should be introduced for ensuring independence of the decisions made at Board level
- x. The format of the Independent Accountant's report³⁸¹ should be changed and the grouping of the transactions as provided in earlier section³⁸² in this study to be incorporated.
- xi. Effective rules to be formulated to regulate Transfer Pricing consultants and impose penalties for issuance of erroneous Transfer Pricing Report or Accountants Report.
- xii. Specific pricing methodologies should be prescribed for respective business models as stipulated elsewhere in this study

Recommendation to the Transfer Pricing consultants

Understanding business model and each transaction is important to suggest Transfer Pricing methodologies and documentation for the Company. Taxation objective is one of the objectives and should not be considered as sole objective for Transfer Pricing. While suggesting a Transfer pricing model, the economic

³⁸⁰ Secretarial Audit as Per Companies Act, 2013

³⁸¹ Income Tax Rules, 1961 Rule 10A-10E

³⁸² *Infra*

viability, impact on other statutes and independence of decision should be also considered and should not restrict to taxation objective only.

While preparation of functional analysis or during selection of comparables for benchmarking study, business, products, market and volume should be considered and appropriate weightage should be given for abnormal adjustment. Exceptional items should be identified and properly adjusted. Although cost will be high, detailed segmental analysis and segment wise benchmarking and transactional level analysis will be important for Transfer pricing study.

Institute of Chartered Accountant should formulate a standard for Transfer Pricing Reports to be issued by its members.

Recommendation for improving this study

Application of the tool suggested ³⁸³ on more Multinational Companies and results on the group results to be observed. Global survey about the model suggested to be conducted and more viewpoints to be obtained. The recommendations provided in this study should be applied to study moral implication of the host country employee and impact on the productivity, cost reduction and turnover rate.

³⁸³ *Infra*