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CONFLICTING OBJECTIVES OF CORPORATION AND LEGISLATIONS LEAD TO DISPUTE

The researcher reviewed the accounting and economics literature, government documents¹⁸³, case law and business publications to uncover the underlying rationale of various government regulations. It was revealed during this literature study that the principal objective of transfer price

¹⁸³ Transfer Pricing regulations of various Countries, tax statutes and rules thereunder.

regulations enacted in different countries are aimed to ensure appropriate, transparent and uninfluenced pricing of goods or services exchanged between internal units. By doing so, the respective countries secure their respective shares of revenue.

The tax, accounting, reporting, and regulatory agencies also look for reporting transparency and consistency across countries. The multinational firms want to maximize shareholder value through increase in stock prices, a function of current and long term profits¹⁸⁴. To this end, they try to minimize taxes.

It is argued that by adopting an abusive transfer pricing policy, a MNE can increase its overall profit. Another reason for Group to set artificial transfer prices is the existence of tariffs.¹⁸⁵ It is observed that if the tariffs are based on price of a commodity, an MNE can save tax by underpricing its goods.

A third motivation for a Group to use transfer prices as a tool to shift profits arises when international tax codes imply double taxation of a subsidiary's distributed profits. The companies tends to adopt such method of shifting profits when dividends distributed¹⁸⁶ by a unit located in the host country

¹⁸⁴ See generally, Danka Starovic, Stuart Cooper & Matt Davis, *Maximising Shareholders value*, (Chartered Institute of Management Accountant, 2004) available at http://www.valuebasedmanagement.net/articles_cima_maximizing_shareholder_value.pdf (Last accessed on March 25, 2014)

¹⁸⁵ A tariff is a kind of tax on goods a country import or exports

¹⁸⁶ Dividend Distribution Tax in India is the tax which is required to be paid @ 15% by the company which has declared, distributed or paid any amount as dividend. The provisions of Dividend Distribution Tax are governed by § 115-O under Chapter XII-D and were introduced by the Finance Act, 1997.

attracts withholding taxes but the tax deducted is not allowed to be offset in the country where the dividend recipient company is located. A similar situation arises when a home country deducts tax on foreign income rather than offsetting tax paid on foreign income in other country. In both cases, a multinational avoids tax liability if it repatriates profits by setting artificial transfer prices rather than by paying dividends.

Generally, the ultimate objective of a Group is to maximize profits besides making an endeavor to become best global supplier of its customer. These objectives can be achieved only through calculating a proper costing by the Company for the products manufactured at different units and taking appropriate decision on manufacturing footprint¹⁸⁷ and building service capability.

In absence of any standard approach by the taxation authorities to uncover complex intra-group transactions entered into by a unit controlled by an MNC Group, tax authorities become skeptical about all inter-company transactions, even if those are appropriately priced¹⁸⁸. To secure the interest of the exchequer, new enactments and rules are being framed by various countries which impact business condition and environment which lead to reduction in foreign direct investment and such cautious approach by various MNCs ultimately lead to economic instability in the host country. During scrutiny of the transactions of selected companies¹⁸⁹, the researcher observed that indeed multinational enterprises are in a position to evade a large portion of their tax burdens by manipulating transfer prices of cross-border transactions. Further, the researcher has observed that profits are

¹⁸⁷ Manufacturing footprint decision refers to the decision on what, how and where to produce the goods and services.

¹⁸⁸ Among various cases decided in favour of the assessee by higher appellate authorities, reference is drawn in the matter M/s Nokia India Pvt Ltd v. ACIT, where ITAT Delhi Bench decided in favour of Nokia. 2012(20)ITR(Trib)198(Delhi)

¹⁸⁹ Kindly refer to various examples and case studies narrated in this chapter

shifted from one tax jurisdiction to other using the transfer pricing mechanism due to difference in Corporate Tax rates in respective countries¹⁹⁰.

ANALYSIS OF TRANSACTIONS

While adopting a transfer pricing policy, a group would aim to achieve the high level objectives as listed below:-

- a) An MNC group generally adopts any policy (including but not limited to Transfer Pricing policy) to maximize the Shareholders' value.¹⁹¹
- b) Amongst other factors, dividend pay-out by an enterprise plays an important role in increasing the share price in stock market. Therefore, an MNC group would like to make cash available with the legal entity of the group situated in the country from where the dividend will be distributed.¹⁹²
- c) The researcher has further observed that to avoid litigation in the country where the maximum business of the group is carried on, the Group adheres to the preferred transfer pricing method

To attain the above three objectives, Group may adopt a Transfer Pricing policy which would be termed as one-sided methodology since the

¹⁹⁰ *Ibid*

¹⁹¹ Danka *et al supra* note 155.

¹⁹² The researcher observed that generally parent company is listed in one country from where dividend is distributed to its shareholders. All other units located in other countries are either 100% subsidiary of the parent company or majority stake is held by the ultimate holding company. It is further observed that the IPrights are held with ultimate holding company. If the majority of business is carried on in the country where the ultimate holding company is located, then cost plus method would be treated as the best method for transferring profits to the country where the ultimate holding company is situated. Also the taxation authorities would be satisfied with such approach since their revenue will be maximized.

methodology will comply with the rules of one country. One such methodology is Cost-Plus¹⁹³ Methodology.

However, the researcher has observed that by following such one-sided methodology, the overall objective of the group would not be ultimately attained. This statement may be examined by using the following example:

The researcher observed as follows:-

Business Objective for Transfer Pricing Methodology

Setting up of an optimal Transfer pricing strategy is utmost important for any Company. There are various reasons for setting up an optimal transfer pricing strategy within the division and units of a Multi-national Company. These reasons may be broadly classified under:

- a. Manufacturing strategy to increase market share by leveraging low cost country;
- b. Performance measurement of independent responsibility center;
- c. Product viability decision;
- d. Lot size decision

As discussed in earlier paragraph, the ultimate objective of the holding Company would be profit maximization. Apart from employing other strategies, this objective can be achieved through accurate costing of products sold, appropriate manufacturing strategy and increase in service capability for customers for increase in the market share. The purchase or buy decision¹⁹⁴ is important for the Group in achieving an optimum cost for a product. In case the inputs required for the final output or services are

¹⁹³ *Infra*, Chapter 1: Key Concepts

¹⁹⁴ The Manufacturing strategy includes decision about whether component should be bought from a subcontractor or to manufacture. The decision is generally taken based on the cost advantage.

inaccurately priced, then the same will have an impact on consolidated profits of the whole Group. The examples provided below, will help to examine the situation:-

Case Study 1: Internal Transfers at lower price

An MNC Group having a manufacturing unit in India which produces semi-finished goods for a manufacturing unit located in US which ultimately produces the finished product.

Sales price of finished goods at USA @ 10\$ per unit, Semi-finished goods sold from India for manufacture of finished goods in USA @ 4\$ per unit, cost of goods sold & administrative cost in India 1200\$. Conversion cost @ 3\$ per unit at US.

Table 7: Consolidated Result in the Books of Group

Fig. in US\$

Particulars	Unit	Rate	India	USA	Consolidated
Sales	100	10		1000	1000
Inter unit sales of semi-finished goods	100	4	400	-400	0
Cost of Conversion	100	3		-300	-300
Cost in India			-1200		-1200
Operating Profit			-800	300	-500
Taxation	30%		0	-90	-90
Net Result			-800	210	-590
Percentage			-200%	21%	-59%

In this example, the researcher observed that the objective of ultimate holding company was not achieved mainly due to reasons listed below:

- a) The performance of the unit in India was not assessed properly since the transfer price determined was lower than cost of goods sold.
- b) Although the unit in USA earned 21% profit on sale, the actual performance of the unit in US was also not ascertained properly since the cost for US unit was artificially low.
- c) The objective of the group was not achieved since the Group has a sustained net loss of 59% in consolidated books.
- d) Although the Group was sustaining a loss on the total transaction, it ends up paying tax in US for the profit earned by the US entity.
- e) The Transfer Price may be challenged by the US Customs Authority

The root cause for non-achievement of the Group's objective may be listed as below:

- a) The unit in USA was unaware of the original cost and therefore a lower selling price was set for the product and therefore could not recover all the costs;
- b) In absence of any review mechanism and target cost, there was no urgency shown by the Indian unit to reduce its cost;
- c) The transfer pricing was one sided¹⁹⁵ and artificially lowered;
- d) The tax management and planning was not done for the group as a whole;

¹⁹⁵ One sided Transfer pricing policy refers to those policies which favours one of the trading partners, in this case, the purchasing unit

- e) The make or buy decision was not taken;
- f) The researcher has further observed that a very low transfer price impacted the morale of the employees of the unit in India and therefore the productivity reduced which led to higher inefficiency cost.

On the contrary to the above, the researcher has observed that in case the transfer price for inter-unit sale and purchases is very high then the cost of product for the unit producing the finished goods is increased and therefore the marketability of the product is reduced which lead to loss in market share due to higher price of the product. The higher transfer price for the semi-finished goods sold from an inter-unit may result in higher profitability for the manufacturing unit. This may lead to absence of cost consciousness¹⁹⁶ for that unit. In such a scenario, the unit producing the semi-finished goods will not be sensitive about the cost control and therefore the cost of the goods will increase. Also the purchasing unit will end up paying higher customs duty.

Therefore from the above analysis, the researcher summarizes that a transfer pricing should be set keeping in mind the overall objective of the group. It will not be beneficial for the group to set an improper (both high and low) transfer price for the goods and services sold to an internal unit controlled by the same MNC group.

The researcher finds that while setting a transfer price, it would be proper to treat every unit of the same MNC group as a separate responsibility center and the respective units should be in a position to negotiate with associated enterprises for the cost of the services/products within an acceptable Transfer Pricing framework. The group can always work as an arbitrator for any dispute in price negotiation. However, a controlled or forced pricing will

¹⁹⁶ Cost consciousness is defined in Cambridge Dictionaries as knowing how the cost of the products and services and not wanting to spend more money than necessary

create an economic instability for the group and taxing uncertainties for the unit controlled by the Group in host country.

Taxation Objective for Transfer Pricing methodology

The taxation objective of an MNC for setting of optimal transfer pricing is listed as below:

- a) Avoidance of Double Taxation
- b) Overall Tax minimisation for the Group
- c) Reduction in Tax litigation
- d) Avoidance of future uncertainties

Attainment of the above listed taxation objectives will ultimately help the Group to attain the main objective of increasing Shareholders' value.

Case Study 2 (Transfer Price was set at arm's length)

The MNC having a manufacturing unit in India, would produce semi-finished goods for a manufacturing unit located in US.

It was observed that the consolidated tax liability will be lower in case the transfer price, from a manufacturing unit situated in a higher tax jurisdiction to a purchasing unit situated in lower tax jurisdiction, is set artificially lower:-

Table 8: Consolidated result when Transfer Pricing is set in line with market price

Transfer at Market Price			Fig. in Mn INR
Particulars	Indian Unit	Foreign Unit	Consolidation
Sales	-	100	100
Transfer	60	-60	-
Cost of Goods Sold	-55	-20	-75
Profit	5	20	25
<i>Effective Tax Rate</i>	33%	33%	

Tax	-1.6	-6.6	-8.2
Profit after Tax	3.4	13.4	16.8
Dividend Distribution Tax @ 15%	0.5	Nil	
Profit available for Distribution	2.9	13.4	16.3

The above table shows that in case transfer price is set at market price¹⁹⁷, the overall tax liability for the group is INR 8.3 M and profit available for distribution is INR 16.3 M after dividend distribution tax paid in India.

¹⁹⁷ Market price is calculated based on comparability analysis

Case Study 3 (Transfer Price was set at lower than Market Price)

Table 9: Consolidated result in case Transfer Price is lower than Market Price

Transfer at lower than Market Price			Fig in MINR
Particulars	Indian Unit	Foreign Unit	Consolidation
Sales	-	100	100
Transfer	50	-50	-
Cost of Goods Sold	-55	-20	-75
Profit	-5	30	25
<i>Effective Tax Rate</i>	<i>0%</i>	<i>33%</i>	
Tax **	-	-9.9	-9.9
Profit after Tax	-5	20.1	15.1
Dividend Distribution Tax	15%	0%	
Profit after Tax	-5	20.1	15.1

The above table shows that in case transfer price is set lower than market price, the overall tax liability for the group is INR 9.9 M and profit available for distribution is INR 15.1 M, which is lower than profit available for distribution shown in Table 10.

The above analysis shows that transfer at Market price is always good for consolidated tax liability. The consolidated tax liability will be reduced in case the transfer is at market price.

Additionally, the performance of the respective units can be measured separately for appropriate decision to improve its cost competitiveness and productivity.

***Deferred Tax generation is ignored for this example*

Increase in Cash flow and consolidation in country where investment and distribution of dividend is planned

An MNC group may set manipulative transfer price to consolidate the available profit at a place from where the distribution of dividend will take place. However, in the above analysis, it shows that a thumb rule approach may not work. In the above example, even if the tax rate is higher in India (including dividend distribution tax), the consolidated tax liability will be lower in the event the transfer pricing is set as per market rate.

Prevailing Hypothesis and current Audit process

It is observed from various court rulings that transfer pricing authorities select companies sustaining continuous losses for detailed scrutiny. However in absence of standardised scrutiny procedure to uncover the complex transactions entered into between associated enterprises, the TPOs also adopt a thumb rule approach to adjust the profitability based on selected comparable companies. However, there are several reasons for such losses which need to be uncovered for establishing the abuse of Transfer Price for transfer of profits, which would be sustainable in court of law. Otherwise, in many instances, we see that even the lower courts add some adjustment to the profitability of the assessee, due to absence of the evidence¹⁹⁸; the assessee gets relief from the appellate authorities. Under the Indian Transfer Pricing regulation a taxpayer is required to justify the transfer prices by application of one of the most appropriate method out of the five specific methods¹⁹⁹ or based on any other method²⁰⁰. A profit/margin-based method is normally considered to be the suitable method in the absence of

¹⁹⁸ Among various cases decided in favour of the assessee by higher appellate authorities, reference is drawn in the matter *M/s Nokia India Pvt Ltd V. ACIT*, where ITAT Delhi Bench decided in favour of Nokia. 2012(20)ITR(Trib)198(Delhi)

¹⁹⁹ *Infra*

²⁰⁰ The other method is defined as any other method which should be equivalent to the prices that would have paid for any uncontrolled transactions with any non-associated enterprise, under similar situation. CBDT has announced the insertion of "Other method" in the transfer pricing rules via a notification applicable from financial year 2011-12.

comparable data for each transactions²⁰¹. However, in case of a loss making company, it is difficult to apply the profit/margin-based²⁰² method.

The onus of proving the application of correct arm's length pricing is placed on the assessee. A taxpayer needs to maintain detailed and complete set of information, documents and facts and figures to prove the correct application of appropriate methodology to the assessing officer²⁰³. In case the assessing officer forms an opinion that the tax payer did not maintain a correct set of documents/information or data, he may adjudicate an upward adjustment to the taxpayers income after giving the assessee an opportunity to be heard.

Taxpayers normally argue that the external business factors contributed to the losses and not an abusive transfer price. However, it is seen that such argument are often ignored during course of the audit²⁰⁴ and the assessing officer passes an order with upward adjustment to the profit originally disclosed by the assessee as Transfer Pricing adjustment.

However, these additions in some cases are not tenable on the ground of non-maintenance of documents, which are not mandatory, since TPOs failed to make proper adjustments to the profit of the comparable companies in order to compare with the earning disclosed by the assessee. This is important since the business conditions are not equivalent in each case.

It is observed that in various court cases²⁰⁵ even Taxpayers do not use any transaction based or traditional method. Instead, the profit-based contentious method is applied like TNMM²⁰⁶. Margin justification is more challenging than

²⁰¹ Knorr-Bremse India (P) Ltd v. ACIT, Faridabad, [2013(56)SOT349(Delhi)]

²⁰² Profit based method includes Transactional Net Margin Method or TNMM

²⁰³ Income Tax Rules, Rule 10D and 10E prescribed a complete set of documents to be kept in accordance with Income Tax Act, 1961 § 92D.

²⁰⁴ General Motors India Pvt Ltd. v. DCIT {2013(27)ITR(Trib)373(Ahmedabad)}

²⁰⁵ Various court cases are referred in this chapter and elsewhere in this study.

²⁰⁶ Transactional Net Margin Method, which compares the profitability of the selected comparable company to establish the appropriateness of arm's length pricing. However, it

the price comparison since analysis of economic conditions are important in transfer pricing analysis.

There may be various adjustments needed to contrast the profitability of the company with that of a comparable company. Some of the adjustments needed are discussed below:-

Impact of difference in Accounting Principles

The flexibility offered by a choice of accounting treatments distinctly diminish and even distort the comparability of relevant information in the financial statements and also to some extent, towards tax treatment.

In this section, we would discuss the other reasons for losses sustained by MNCs , apart from related party transactions,. Some of those reasons are listed as below:

- a) Treatment of Internally generated assets
- b) Depreciation Rate on Assets
- c) Depreciation on Intangibles
- d) Valuation of Inventory
- e) Valuation of Investments
- f) Accrual of Expenses

Impact of scale of operation

Manufacturing sector

is seen that adjustments needed to arrive at the comparability is often not considered which results in dispute.

Generally an assessee belonging to manufacturing sector, uses Return of Asset (ROA) as underlying PLI²⁰⁷. Capacity utilization adjustment in the case of manufacturing entities are made when some assets - property plant and equipment (PP&E), do not generate sales while depreciation and other expenses of idle assets are reflected in the profit and loss account.

Under-utilization of PP&E implies the ROA is "distorted" compared to ROA at full utilization of PP&E.

Service Sector

The capacity utilization adjustment in the case of service industry is required only where there is a significant difference in hours' utilization rates in the case of tested party²⁰⁸ and the comparable companies.

The above adjustment is required to ensure that the costs attributable to the unutilized hours are removed from the total employee related costs.

Case Study 4: Impact of Scale of Operation

Impact of adjustment for underutilization of excess capacity (assumed that average utilized capacity of the industry is 85%) is shown as under:

Table 10: Impact of underutilization on Profitability of a Manufacturing Industry

Year Ended	INR
Sales (i)	237 crore
Cost (ii)	225 crore
Operating Profit (iii=i-ii)	12 crore
Cost plus mark up (iv = iii/ii * 100)	5.3%

²⁰⁷ Ratio that measures the relationship between an entity's profit and the resources invested or costs incurred to achieve that profit.

²⁰⁸ Tested party is the company which is selected to compare the profitability of the assessee

Unutilized capacity adjustment (70% utilization)	40 crore
Adjusted operating profit (vi)	52 crore
Adjusted cost plus mark up (vii = vi/ii * 100)	21.9%
Increase in cost plus mark up	16.6%

Table 11: Impact of capacity adjustment for a Service Industry

Year Ended	INR'000
Head Counts (a)	400
Maximum number of hours per employee (assume 260 days)	2,080
Total available hours (c=a*b)	8,32,000
Utilisation rate (d)	74%
Utilised hours (e=c*d)	6,15,680
Unutilised hours (f=c-e)	2,16,320
Unutilised hours after considering industry standard unutilized rate of 15%	91,520
Unutilised head counts (91,520/2,080)	44
Employment related cost	5,40,165
Adjustment to the total employment related cost	59,418

Impact due to Working Capital difference

Performing working capital adjustment is necessary to ensure that return derived from a set of comparables can be applied reliably to a tested party operating in a non-arm's length setting.

Because the rationale behind the adjustment is economically sound, tax authorities, administrations in many countries across the globe accept/recognize this concept and usually require or at least recommend that taxpayers make such adjustments during the course of defending a transfer pricing audit, or while preparing an advance pricing agreement (APA) to ensure that the results are comparable by smoothing differences in working capital levels amongst otherwise functionally similar companies.

In the United States, working capital adjustments are not only advocated by the Internal Revenue Services (IRS) but are also incorporated in all economic analysis.

An argument for working capital adjustments has also been advocated in an article appearing in *article published by BNA*²⁰⁹ wherein it has been argued that the advantage of applying working capital adjustments as a rule rather than on a case-by-case basis is that it eliminates the subjectivity in deciding whether to perform the adjustments.

There is no theoretical argument that suggests that working capital adjustment should be rejected. The analysis shows that operating in a perfectly competitive environment implies that working capital adjustment is required²¹⁰. These findings are supported on theoretical grounds, which are violated when different working capital intensities exist between firms. Given that forms are assumed to be price takers, the only way that prices charged by all firms can be taken as given as if all factors that affect prices, including working capital intensities are the same. Though theory supports the use of working capital adjustments, the need to perform such adjustments is not universally accepted. However, failure to perform working capital adjustments may result in a significant difference in the profits assigned to a tested party.

Case Study 5: Impact of Working Capital difference

The following table shows the impact of working capital adjustment:-

²⁰⁹ Accord, Jamal Hejazi, *Tax Management Transfer Pricing Report*, Vol.14 (24) (Dec. 2006) available at [http://www.google.co.in/url?url=http://http-server.carleton.ca/~jhejazi2/workiingcapital\(v1\).DOC&rct=j&frm=1&q=&esrc=s&sa=U&ei=7PxQVfDBEYf18gWj9YCoBg&ved=0CBsQFjAC&sig2=pS8PNDEbbyRmXUVNtT9o8w&usg=AFQjCNGe4psWEsti5tVYG06ifBSrjTkYPA](http://www.google.co.in/url?url=http://http-server.carleton.ca/~jhejazi2/workiingcapital(v1).DOC&rct=j&frm=1&q=&esrc=s&sa=U&ei=7PxQVfDBEYf18gWj9YCoBg&ved=0CBsQFjAC&sig2=pS8PNDEbbyRmXUVNtT9o8w&usg=AFQjCNGe4psWEsti5tVYG06ifBSrjTkYPA) (Last accessed on March 20, 2011)

²¹⁰ *ibid*

Table 12: Impact of Working Capital on Profitability

Particular	Reference	Comparable Company	Tested Party
Sales	A	100	500
Operating Cost	B	90	400
Purchases	C	40	200
Cost of Goods Sold	D	50	200
Operating Profit	E=A-B	10	100
Operating Profit Margin (PLI)	F=E/A*100	10%	20%
Inventory	G	10	100
Inventory adjustment	$H=(100/500)-(10/100)*100*0.1$	1	-
Capital adjusted operating margin	I	11	-
Adjusted Operating Profit		11%	

Business Risk adjustments

Risks are those business factors that may expose a company to the possibility of loss or damage. The Capital Asset Pricing Model (CAPM)²¹¹ is a well-known model used by the analysts to determine the “price” or market risk, and estimate the return that is embedded in the market average return that can be attributable to the market risk faced by the comparable companies. The various types of business risks are mentioned in the table below:-

Table 13: Business Risks and their impact

S.No.	Type of risk	Particular
1.	Market Risk	Market risk arises when a company is subject to adverse sales conditions due to either increased competition in the market place, adverse demand conditions within the market, or due to

²¹¹ Capital Asset Pricing Model is used to determine a required rate of return on any asset employed.

		the inability to develop markets or position products to service targeted customer
2.	Warranty/Product liability risk	Product liability risk arises when a company's product fails to perform at accepted or advertised standards or, in extreme cases, even cause bodily harm to the user.
3.	Credit Risk	<p>When a company supplies products or services to a customer in advance of customer payment, the company runs the risk that the customer will fail to make payment. This risk is known as customer credit risk.</p> <p>It is possible to quantify the credit risk by examining the costs associated with bearing the risk for inclusion in the cash flows either via insurance, hedging via credit derivatives, or self-insurance.</p>
4.	Foreign Exchange Risk	Exchange rate risk related to the potential variability of profits that can arise because of changes in foreign exchange rates. Such risks arise when doing business in any market that is affected by international trade and can arise even if a company does not conduct actual transaction in foreign currency
5.	Inventory Risk	Inventory risk relates to the potential losses that are associated with carrying finished product inventory. Losses include obsolescence, shrinkage or market collapse such that products are only saleable at prices that are inadequate to cover the company's product cost.
6.	Volume Risk	Volume risk is a function of the way in which the companies derive their revenue. To the extent the comparable companies are exposed to volume risk, forecasting risk which relates to the forecasts of costs and revenue becomes an issue.

Issues faced by an MNC Company with Overseas Operations

A multinational organisation present in various countries faces several challenges due to difference in statutes and economic conditions of respective countries. Some of those challenges are enumerated as below:-

- i. Transfer pricing policy is adopted by a multinational organisation keeping in mind the regulation of a country where maximum business is carried on.. In case of a multinational organisation, adoption of a

transfer pricing policy, which caters to the need to all countries where such organisation is present, is an enormous task due to which companies are compelled to adopt contentious margin based methods which require margin justification than the justification about the price of such transaction.

- ii. This is quite difficult to consistently balance Local and overseas Transfer Pricing compliance. It is observed that in some cases, a company, to avoid adoption of multiple Transfer Pricing Policy, adopts a one-sided methodology (Like Cost – Plus) which lead to dispute with TP authorities of other countries.
- iii. Maintenance of documentation in uniform way to cater to the need of all authorities is an enormous task, which requires standard tools and manpower.
- iv. Selection for basis of Management / Corporate services and to prove receipt of services in host country is a big challenge for any multinational group.
- v. Loans extended to overseas subsidiaries where Thin Capitalisation²¹² provision has been already enacted, can be an issue, if the debt-equity ratio is not maintained in that country.
- vi. Excess profit/Super profit issue can be another challenge for companies where such provision is applicable²¹³.
- vii. Provision of services and secondment fee²¹⁴ charged on such services always creates some issues and makes it onerous to prove that the

²¹² A Company is said to be thinly capitalized when its capital is made up of a much greater proportion of debt than equity

²¹³ In the United States, an **excess profits tax** is a tax, some say excise tax, on any profit above a certain amount.

nature of services commensurate with the services rendered by such person.

- viii. Transfer Pricing authorities tend to scrutinize in detail for any off-shore services rendered by member of staff while undergoing training in that country.
- ix. Since Transfer Pricing is a subject which is evolving very fast globally, tracking international developments in this field and adoption of an updated policy is very crucial for successful implementation of the policy.

²¹⁴ Secondment means the transfer, on loan, of a member of a staff of a department to another body corporate, for a temporary period.

Case Study 6: Comparison of Financials of an Indian Company and an MNC

Table 14: Balance Sheet of Indian Company Limited

Indian Company Limited		Fig in MINR			
Particulars	Year 1	Year 2	Year 3	Year 4	
<u>Source of Funds</u>					
Share Capital	100.0	100.0	100.0	100.0	
Reserves	(2.0)	(6.0)	(4.0)	(2.0)	
<u>Application of Fund</u>					
Fixed Assest incl Building	50.0	80.0	76.0	72.0	
Inventory			5.0	7.0	
Cash at Bank	46.0	9.0	11.0	16.0	
Intangible	2.0	5.0	4.0	3.0	
<u>Income</u>					
Sales	Nil		50.0	60.0	
Adjustment for Stock			5.0	7.0	
<u>Expenses</u>					
Material Cost			30.0	40.0	
Processing Cost			10.0	10.0	
Fixed Salary	1.0	2.0	5.0	7.0	
Share Issue Expenses	2.0				
Misc Prof Fee	2.0	2.0	1.0	1.0	
Travelling Expenses	1.0	2.0	1.0	1.0	
Other Expenses	1.0	1.0	1.0	1.0	
Depreciation @ 5%			4.0	4.0	
Expenses Capitalised	(2.0)	(3.0)			
Amortised			1.0	1.0	

Note: Capitalized Expenses are expected to generate future revenue and meets the guidelines of Accounting Standard on Intangible (AS-26)

Table 15: Balance Sheet of an MNC

MNC Limited		Fig in MNR			
Particulars	Year 1	Year 2	Year 3	Year 4	
<u>Source of Funds</u>					
Share Capital	12.0	24.0	124.0	124.0	
Reserves	(8.7)	(17.4)	(38.5)	(42.7)	
<u>Application of Fund</u>					
Fixed Assest	2.0	1.6	73.5	65.3	
Inventory				7.0	
Cash at Bank	0.8	4.0	11.0	8.0	
Deffered Revenue Expenses	-	-	-	-	
<u>Income</u>					
Sales	Nil			50.0	
Commission from Sales	0.5	0.5	2.0	2.0	
Adjustment for Stock				7.0	
<u>Expenses</u>					
Material Cost				30.0	
Processing Cost				10.0	
Fixed Salary	2.0	2.0	4.0	7.0	
Share Issue Expenses	1.0	1.0	2.0		
Misc Prof Fee/Formation	1.0	1.0	2.0	1.0	
Travelling Expenses	1.0	1.0	2.0	1.0	
Other Expenses	1.0	1.0	2.0	1.0	
Rent	3.0	3.0	3.0	3.0	
Depreciation @ 10%	0.2	0.2	8.2	8.2	
Expenses Capitalised					
Amortisation of Intangibles					

The comparative analysis of financials for both the companies reveals that the main difference was the Accumulated Reserve balance due to profitability of these Companies during initial years. In case of Indian Company, it is positive reserve which is distributable profit, however in case of an MNC with similar situation after 4 years the Company has a negative reserve and therefore may remain effectively NIL tax rate Company for some years. Apparently it can be perceived that the losses sustained by the MNC are mainly due to abusive transfer pricing. After detailed analysis, it was observed that during initial years of operation, the transaction of the MNC was only limited to earning of commission from sales, whereas the expenses include market survey cost which was not matching with the earning. However, some of the costs were considered as an asset and would be amortised as per accounting principle.

It was noted that in the initial years, the losses sustained by the MNC were not contributed by the inter-company transactions. Therefore, simple comparison with Indian Company would not always results into correct comparison. The understanding of business conditions and a proper functional analysis would be required for a correct comparability.

Indian tax authorities and transfer pricing officers (TPOs) generally ignore the importance of value addition and risk analysis in Transfer Pricing matters. It is a fundamental principle of economics that enterprises which undertake low risk can expect only to yield low profits²¹⁵. This principle was also admitted by Delhi Income Tax Appellate Tribunal (ITAT) in its recent landmark decision of *Mentor Graphics (Noida) Private Limited v. Dy. CIT ITA*,²¹⁶ which has revived

²¹⁵ Risk and Reward relationship is defined in Capital Asset Pricing Model(CAPM), which was developed in 1970s and is extensively used by the financial analyst. This model calculates the expected return based on risk differential.

²¹⁶ 2007 (109) ITD (Trib) 101 (Delhi)

the confidences of taxpayers. In this case, Mentor Graphics Private Limited (Noida) was engaged in the business of software development and rendering marketing systems services to its parent company, IKOS Systems Inc. based in USA. Mentor Graphics adopted TNMM as Transfer Pricing methodology for benchmarking its transfer price for the software development services rendered by the Company. The Company also used Net Cost Profit (NCP) as the price level indicator for benchmarking. the Assessing Officer accepted the revised NCP at 23.53% calculated by TPO based on an independent search, and accordingly made an adjustment of Rs.14.5 million to the company's taxable income which was upheld by the Commissioner (Appeals). However, ITAT concluded that search conducted by the TPO had serious defects affecting the ALP and ruled that the decision was incorrect, since ITAT emphasized that appropriate adjustments relating to functional, asset and risk differences are necessary while choosing comparable enterprises in TP analyses.

Use of secret data

In a survey conducted by practitioners from 26 countries, it was found that many developed countries do not use secret comparables during Transfer Pricing assessments.²¹⁷ However in India, there is no such regulations and tax authorities are free to use such secret comparables during transfer pricing assessments.

Transactions involving intangibles

At present, TP regulations have no specific provisions for transfer of intangibles and the five prescribed methods are often found inadequate to deal with TP issues relating to intangibles

²¹⁷ Kevin Bell, *Treatment of Secret Comparables* (Thomson Reuters, October 2, 2013) available at <https://tax.thomsonreuters.com/blog/onesource/transfer-pricing-global-tax-compliance/bloomberg-bna-transfer-pricing-forum-examines-treatment-of-secret-comparables/> (Last accessed on June 12, 2015)

Burden of Proof

With the significant increase in overseas transactions and between related parties, transfer pricing has become an important daily activity for global enterprises. However considering the trade deficits and revenue collection pressure for development of the host countries, revenue authorities have become increasingly skeptical about possibilities of tax evasion by MNCs. Continuous use of the word "Transfer Pricing" which has become almost synonymous to "Tax evasion" in most of the countries, Corporations are facing severe challenges during tax assessments in every host countries. It is also true that Corporations are in position to divert 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 find Transfer pricing related issues as opportunities to increase revenue collection. The situation also has worsened with increased scrutiny of transfer pricing and stringent rules at some of the developed countries. The developing countries like India, to secure their revenue, has also formulated lot of new procedures and rules for transfer pricing management.

The revenue authorities, to avoid any miss from their end to unravel the existence of abusive transfer pricing, have started disputing majority of inter-company transactions²¹⁸. This has resulted in huge disagreements between revenue authorities and corporations on the issue of taxable income reported in almost every jurisdiction. Although tax treaties are available and dispute resolution mechanism 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 that the first

²¹⁸ *India Transfer Pricing Survey, You Said It* (PWC, February 2015) available at https://www.pwc.in/en_IN/in/assets/pdfs/publications/2015/transfer-pricing-in-india-you-said-it.pdf (Last accessed on March 20, 2015)

level authorities do not agree with the transfer pricing mechanism adopted by the companies and therefore demand a huge tax with penalties and interest. This has resulted in double taxation in some cases and in others, the matters are being referred to tribunal for solution, which is increasing the litigation cost for these business giants as well as exchequer.

The Companies are facing severe challenges due to these uncertainties. The researcher would like to highlight that any unstable and non-transparent tax rule may have an impact on business ease index²¹⁹ and confidence amongst the foreign investors. In absence of confidence amongst the investor, the FDI inflow will certainly slow down. With the increased pressure from the economic situations coupled with difference in accounting rules, the businesses are facing severe financial challenges. In this challenging economic situation, the investors can be frustrated with the aggressive taxation policies²²⁰. This situation can pose a risk in the nature of:-

- I. Taxation uncertainties and tax demands;
- II. Penalties and Interest;
- III. Once assessed negatively, there is a huge potential of being assessed on the same lines for future years;
- IV. Double Taxation and absence of relief under tax treaties;
- V. Related tax consequences like withholding tax;

²¹⁹ The ease of doing business index is an index created by the World Bank Group. Higher ranking means simpler regulation for business and higher ranking (a low numerical value) indicates better.

²²⁰ In ET Global Business Summit, Indian Finance Minister Mr. Arun Jaitley commented that "Unfair and aggressive taxes momentarily will give me a false belief that my taxation kitty will be very large. But none of the controversial cases has brought me a single rupee of revenue, it has only brought the Indian economy a bad name. Ultra-aggressive taxes have not yielded any revenue," he said, adding that some tribunal or the other struck down the claims". The article is available at http://articles.economictimes.indiatimes.com/2015-01-17/news/58175313_1_finance-minister-arun-jaitley-land-acquisition-act-rajya-sabha-numbers (Last accessed on March 20, 2015)

- VI. Uncertainties for the future earning potential for the investors due to huge tax burden which can create challenges to meet the overall group taxation objectives. In some countries²²¹, the company may face lawsuits also for not meeting the earning forecast;
- VII. Unfavourable transfer pricing adjustment may result into litigation with indirect taxation authorities;
- VIII. Dispute with other regulatory authorities;
- IX. Other than the financial impact, damages the brand value for not being a responsible corporate citizen and can eventually impact the financials of the Company;

The above situation now demands for appropriate and correct planning and documentation of transfer pricing policies and procedures.

The researcher has observed that Corporates generally adopts transfer pricing policy which aims to cater the global tax planning objectives. The policy also will narrate the implementation and monitoring plan. Generally, corporations adopt a defensive transfer pricing strategy. However, the defensive strategy is formulated for the country where the majority of the business is located and also where the risk of being penalized is high for non-compliance of Transfer Pricing regulation. The adoption of Transfer Pricing policy to satisfy the Transfer Pricing regulations of one country may create an issue for the companies which have business presence globally, since the policies adopted may not satisfy the Transfer Pricing regulations of the other country

Even if the companies are adopting defensive strategies, it is observed in various court rulings that transfer pricing transactions will be challenged in absence of proper and appropriate documentation. It is seen that mainly,

²²¹ Securities Act of 1933 (USA) § 11 & 12 imposes liability on issuers, their officers and directors and underwriters in a public offering for oral or written misstatements or omission of facts necessary to make that statement not misleading.

services (especially Shareholder services)²²² are challenged during assessments.

The countries have now formulated a detailed rule and regulation to regulate transfer pricing issues. However, in absence of any specific guidelines for respective transactions or a genus of transactions about the documentation requirement, processes, it is left to interpretation of the situation. The taxpayers are expected to explain and submit documentary evidence to substantiate that the price paid for the goods and services are at arm's length. Although Advance pricing arrangements are available in most of the countries, the intended utilization of this tool is exceptional tool for the biggest taxpayers. Therefore, the burden to prove that the transactions between related parties are made at arm's length, lies on the Corporations.

The researcher has observed that the uninfluenced pricing may also create opportunities for the Group to improve its profitability and productivity. Since the adoption of a robust transfer pricing policy requires involvement of cross functional team, evaluation of each business situation may be done through this process and business priorities can be determined through careful analysis of the respective situations. This process will help Corporations to make this a tool to support not only the tax objectives but also to attain the business objective and for fair evaluation of the units.

Important court rulings on Transfer Pricing:

- (1) *DIT v. Morgan Stanley & Co.*,²²³ In this case the matter related to deriving profits which are attributable to permanent establishment was decided. In this case, it was adjudicated that in case the transfer pricing analysis was done and the appropriateness of arm's length

²²² 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.

²²³ (2007) 292 ITR 416 (SC)

pricing was established, there is no requirement for attributing profit to permanent establishment. In case the transfer pricing analysis does not reflect the functions and risk assumed, the profit with regard to those functions and risks not considered, need to be attributed.

(2) **Coca Cola India Inc. v. ACIT**,²²⁴ In this matter, the High court observed that the transfer pricing provisions was not result of any legislative incompetency. The provisions were made applicable on foreign companies to remediate any possibility of tax evasion. The High court also observed that it is not required to establish that there is a transfer of profit before applying these provisions. Also it is not mandatory to give a hearing before referring the matter to TPO for transfer pricing audit.

(3) **Moser Baer India Ltd v. ACIT**,²²⁵ In this matter the Delhi High Court observed as below:-

- a. Section 92CA (3) of Income Tax Act imposes an obligation on the TPO to provide an opportunity for an oral hearing before the order is passed.
- b. Even in case where assessee is unaware of his legal rights, the obligation of state is not diluted if the assessee has not demanded for an oral hearing.
- c. The argument was not accepted by the High Court that the opportunity for the oral hearing can be given in the tribunal proceeding.

²²⁴ (2009) 309 ITR (HC) 194 (P&H HC)

²²⁵ (2008) 13 ILR (HC) 125 (Delhi)

- d. During the issuance of show cause, the assessee should be given an opportunity of being heard.

(4) **Philips Software v. ACIT (ITAT Bangalore)**²²⁶ The Tribunal held as below:-

- a. Before passing an order, the AO needs to demonstrate that there is an intention to transfer profit out of India. In this case, since the assessee was enjoying tax holiday, the motive for transferring profit out of India was not established by the AO during the issuance of order.
- b. The AO cannot change the methodology and database used by the assessee without showing the reason for rejection.
- c. Adjustments are required to be made to arrive at comparable profit for all the functional and other differences.
- d. The standard deviation allowed in this section should be available to the assessee.

(5) **Sony India (P) Ltd. v. DCIT**²²⁷: The court held in this matter that the adjustments made by the TPO to derive the operating profit was not justifiable since the liabilities no longer required written back, insurance claim etc, which was deducted from the operating income, it was not at all an operating Income. These are part and parcel of the normal business transaction and were held to be considered while computing the operating profit.

²²⁶ 2008 (119) TTJ (Trib) 721 (Bang)

²²⁷ (2008) 114 ITD (Trib) 448 (Del)

(6) **Development Consultants v. DCIT**²²⁸: The court held in this case that the action of the TPO to disregard the transaction-by-transaction analysis and applying an entrepreneurship approach for deriving the arm's length pricing was inappropriate and therefore upward adjustment derived from that global approach was not accepted.

(7) **The DHL case 1998**²²⁹: DHL Corporation²³⁰, along with its foreign affiliates referred to as DHLI, was involved in package delivery business with DHL managing the US operations and DHLI the international business. DHL grew the brand in the US and DHLI, which was licensed to use the "DHL" name on a royalty-free basis, registered and developed the trademark worldwide outside the US.

DHL/DHLI shareholders agreed to sell controlling interest in DHLI to a consortium. The deal was structured as a minority investment by the consortium initially (12.5 per cent in DHL and 2.5 per cent in DHLI), with an option to purchase 45 per cent stake in DHLI at a later date. Further, DHL granted DHLI a restrictive right to purchase the 'DHL' trademark for \$20 million. This right was, however, subject to exercise of the option to acquire further stake in DHLI by the consortium.

The consortium exercised this option within the specified period. The Internal Revenue Service (IRS) held that the transfer pricing provisions under Section 482 of the Internal Revenue Code (IRC) were applicable to the transfer of DHL's valuable trademark to DHLI

²²⁸ (2008) 115 TTJ (Trib) 577 (Kol)

²²⁹ (T.C. Memo no. 1998-461), US Tax Court, Docket Nos. 19570-95, 26103-95

²³⁰ Available at <http://www.transferpricing.com/pdf/DHL.TCM.WPD.pdf> (Last accessed on March 20, 2015)

as 'control' was manifest between DHL and DHLI and it concluded that the trademark's arm's length price as \$600 million.

The lower tax court held that IRS was right in its basic premise, however it valued the trademark at \$100 million. DHL appealed against this decision to the Courts of Appeal (CA). The CA segregated the trademark between non-US and US components and valued each at \$50 million. It was concluded that DHLI was the developer of the international trademark and no allocation to DHL was appropriate for such value. Further, penalty was not levied for undervaluation as DHL had relied on the independent valuation it had obtained.

A careful reading of the case would highlight the following significant guidelines for defending transfer-pricing litigations, especially relating to intangibles-Documentation is very important. Clear and well-reasoned inter-company legal agreements must be in place. A taxpayer's reliance on professionally advised methodology of preparing documentation is reiterated as a good practice, mitigating the taxpayer's risk of being levied penalty.

(8) ***Ranbaxy Lab. Ltd. v. Addl. CIT***²³¹ : The Company was a multinational company engaged in manufacture and sale of pharmaceuticals products. The dispute between Ranbaxy and the income tax department was about the method adopted by the company for valuing the goods sold and services rendered to overseas AEs, situated in countries like US, the UK, Germany and China.

²³¹ 2008 (114) TTJ (Trib) 1 (Delhi)

The Company had adopted TNMM as appropriate method for determination of arm's length pricing. The Company also selected an overseas entity as tested party for benchmarking purpose. The Company submitted that the prices charged was at arm's length by comparing the net profit of the selected party. The tax department disputed the methodology adopted by the Company since it believe that the process does not follow the generally accepted principles under Income tax Rules for the purpose.

The ITAT in its ruling held that the Commissioner of Income tax can revised the order passed by an assessing officer, if the Assessing officer had erred in its judgment and not considered relevant facts while determining the arm's length price. The ITAT also ruled that the Arm's length price (ALP) could be determined appropriately if the reliance was placed on the prices charged for similar transactions by domestic pharmaceuticals companies rather than applying TNMM in this case.

The ITAT also rejected the selection of overseas entity as tested party by the Company for determination of ALP as ITAT believed that the Company had not considered important factors like geographic location, economic environment and functions performed by such entity.

Observations from the Court Rulings

The researcher has observed from various court rulings that In almost all occasions Companies are preparing documentation and justifications in host country after the transactions is already completed due to a one-sided methodology is adopted by the Group to adhere to the regulations of the country where the main businesses are undertaken. Hence the justifications and documentations provided for proving appropriateness of arm's length pricing is reactive, defensive and inadequate. The analysis and comparable data collation is used for assessment proceeding and not for deciding the best methodologies for the transaction. The reactive action to adopt transfer pricing methodology leads to taxation litigations and taxation uncertainties. The researcher observed that it is absolutely necessary to be co-operative with the tax authorities by providing them the required information, since the onus is on the assessee to maintain proper records to justify the arm's length price.

A careful study of the existing statutes and various court rulings reveals very limited scope to uncover the complex transactions entered between associated enterprises and the abuse of transfer pricing. This complexity creates uncertainties for Corporates and revenue loss to exchequer. This data collection process for this study was done keeping in mind the importance of following 4 (Four) stage process for adopting an optimum Transfer pricing policy. The stages are:

- I. Transactional level functional and risk analysis;**
- II. Understanding the importance of Corporate Governance and impact on other statutes;**
- III. Identifying economic value addition at various stage;**
- IV. Pricing calculation based on value addition.**

Data collection

To comprehend the transfer pricing complexity in light of complex inter-group transactions entered between associated enterprises and its impact on business and exchequer, the researcher conducted a field-based study and analyzed financials of 7 Multinational Companies(MNC) which is present in at least 26 countries including but not limited to India. The MNC's were selected carefully to ensure that these entities are currently engaged in all spectrums of activities which are subject to Transfer Pricing scrutiny. This data collation process helped to analyse various types of transactions and also helped to increase the model's diversity from the perspective of corporations to revenue authorities encompassing majority of the stakeholders of Transfer Pricing process. Data has been analysed for the financial years 2010-11 to 2013-14. An empirical methodology has been adopted for the data analysis since this method was most appropriate to test the ideas evolved encompassing different scenarios and environment and different business models. The application of the proposed methodology on different circumstances and analysis of the result revealed the importance of understanding the business model, economic value addition based pricing, decision making under controlled environment and its impact.

Amongst the selected companies, there are 1 office automisation Company and 1 vertical mobile solution (Lifts and Escalators) Company, 2 Chemical manufacturing Company, 2 Engineering Companies, 1 Service Provider Company. These Companies are Multi-national enterprises with headquarters in USA, UK, Saudi Arabia and Europe respectively The Business Models of these Companies are as below:-

The inter-group transactions of these Companies are of diversified nature.

The activities of these companies can be bifurcated into following:-

- a) Contract Manufacturing of semi-finished products for associated companies.

- b) Contract Manufacturing of final products for associated companies
- c) Service Provider for associated companies
- d) Distributors for associated companies
- e) Commission agent for associated companies
- f) Service receiver
- g) R&D hub
- h) Financing
- i) Engineering Center
- j) Erection and Commissioning Service

Importance of Transactional level functional and risk analysis

It is important to note the comments made by DRP (Dispute Resolution Panel) in one of its judgment²³² which was as below:

It is seen that the Indian Transfer Pricing Regulations as well as OECD Guidelines state that the transactions profit method should be ideally be applied on a transaction to transaction basis but in appropriate situation, transaction may be aggregated or grouped. Essentially the relevant controlled transactions may best be aggregated if it is impractical to analyze all the profits of each individual transaction or if such transactions are so inter-related that this is the most reliable means of benchmarking the outcome of the transactions against the arm's length transaction. It is seen that in case of most of the individual transactions, the working of separate profitability and separate benchmarking is feasible but same has not been done. It is for this reason that the margins were calculated at entire manufacturing segment which now results into adjustment. The assessee itself has defaulted by not submitting the transaction wise profitability by virtue of which the TPO had no other option than to refer the segment-wise transaction as a whole.

Further to the above, the Panel also commented as below:-

²³² In the matter of Eaton Fluid Power Limited v. ACIT, DRP Pune (Unpublished), 2015

The most obvious problem in the analysis is that of benchmarking the import material which was used for manufacturing of the power units and valves and series 5, as in the production of these two items, the most of the components are sourced from the AE. Further, these components are entirely different from the components sourced from the third party which were used for the production of gear pumps and cylinders sold to the third party. Thus no comparison is possible in this case by using internal comparable for the simple reason that both the raw material used for production and the final products sold are different from each other radically. The approach of the assessee to benchmark the international transactions by using internal TNMM thus suffer from a serious lapse that the comparability is being made where there are neither similar raw materials nor the finished products.

According to the above observations made by DRP, the researcher would like to recommend that to avoid any uncertainties and future risk for the Corporations and to avoid any loss to exchequer, a detailed analysis of the business model needs to be undertaken for adoption of an appropriate transfer pricing policy. The importance of functional analysis can be understood from the scrutiny of different types of inter-group transaction as provided below:

Manufacturing

The manufacturing process may vary from a simple to a complex manufacturing process. In the context of arm's length pricing calculation, the amount of profit to be allocated to a manufacturing unit should be dependent on manufacturing model, assets deployed and the risk assumed by the entity. The factors which would distinguish between one types of manufacturing activity from another would primarily be the difference in the degree of risk assumed in executing the manufacturing function, the kind of assets (tangible and intangible) deployed in the manufacturing set up and the function discharged during the conduct of the manufacturing activities. Based on the aforementioned three factors, manufacturing operations can be classified as:

1. Toll Manufacturing

2. Contract Manufacturing and
3. Full-fledged manufacturing activity

A brief overview of each kind of manufacturing activities is discussed hereunder:

(1) **Toll Manufacturing:** Toll manufacturing refers to an arrangement in which an entity processes raw materials or semi-finished products for another entity²³³. In a toll manufacturing arrangement, the title to the goods always vests with the principal entity throughout the manufacturing process. Principal procures the raw-materials and assumes all the linked inventory and market risks. Hence, the toll manufacturing entity is a basic service provider who does not engage in any activity such as procurement or sometimes, even production scheduling. No manufacturing intangibles are owned by the toll manufacturer, and there is no conduct of independent research and development activities. A toll manufacturer would be assured of a guaranteed volume of business for which compensation would be in the form of a **cost plus model**.

(2) **Contract Manufacturing:** A typical contract manufacturer would be employed to undertake defined product manufacturing or assembly of processes. Contract Manufacturing as a “Term used to refer to a variety of arrangements under which the central feature is that part or all of a manufacturing process is “outsourced” by one party (Often referred to as the “principal”) to another party”²³⁴ A contract manufacturer is comparable to a toll manufacturer in more ways than

²³³ Available at <http://www.businessdictionary.com/definition/toll-manufacturing.html> (Last accessed on June 20, 2015)

²³⁴ Available at <http://www.businessdictionary.com/definition/contract-manufacturing.html> (Last accessed on June 20, 2015)

one. The contract manufacturer is also a service provider who renders services according to specification and standard set by the principal. However, one distinguishing feature that separates a toll manufacturer from a contract manufacturer is the fact that the latter procures its own raw materials and will have the title of the goods so procured. The intangibles owned by the contract manufacturer would be severely restricted to the know-how embedded in the manufacturing process and the contract manufacturer would not assume ownership of any valuable/proprietary technology. The contract manufacturer does not develop product lines or provide any marketing and other associated support functions to its principal manufacturer.

- (3) **Full-fledged Manufacturer:** A full-fledged manufacturer would carry out manufacturing and assembly function and would typically own the fixed assets required for the production process²³⁵. The manufacturer would have the title to the raw materials/inputs and would be the owner of the work-in-progress. The manufacturer is also likely to own intangible property and it is this element in particular that adds to the complexity for deriving arm's length pricing. The full-fledged manufacturer would also independently conduct research and development activities and would bear the risks associated with inventories, products and the market.

Thus it may be noted that a full-fledged manufacturer, in sharp contradiction to a toll manufacturer and a contract manufacturer,

²³⁵ *TP in the Manufacturing Sector-Transformation and New Challenges*, INTERNATIONAL TAX REVIEW (September 2014) available at <http://www.internationaltaxreview.com/Article/3382024/TP-in-the-manufacturing-sector-Transformation-and-new-challenges.html> (Last accessed on June 20, 2015)

undertakes a broader gamut of functions and assumes a wider element of risk.

For benchmarking transfer prices of product manufactured by a full-fledged manufacturer, it is far more difficult to test the arm's length return, particularly where embedded cost of intangible assets development and ownership of the intangible is significant. Here cost and tangible assets employed are not the only value drivers in play and therefore payment by reference to them is likely to miss the mark. In a variant of the full-fledged manufacturing model, the intellectual property (IP) may not be owned by the manufacturer. The IP may be licensed to the manufacturer by an IP owner which might either be an associated enterprise or an independent unrelated party. Under such circumstances, the manufacturer would be making payments by way of royalty for the licensed technology/know-how. If the royalty is paid to an associated enterprise, such payment would also be an international transaction for the purpose of transfer pricing.

A common model for MNCs is to separate manufacturing and sales/distribution activities. Where the manufacturing process is complex, the sales entities would by definition, be relatively simple with manufacturer bearing most of the risks of the overall activity. In this case, allocating arm's length rewards to the sales entities and allowing all the residual profit/loss to back up into the manufacturer would be the most appropriate approach. This relies on the premise that if prices paid by the sales entity are at arm's length, then the balance received by the manufacturer, whatever it might be, is also at arm's length.

Importance of Risk and Reward Analysis

A fundamental theory embedded in any business activity is that rewards accruing to the business ought to be proportionate to the risks assumed in such an activity. The risks assumed in the various manufacturing models mentioned above varies and hence as a corollary, the rewards which would be expected from assuming such risks would also vary. The following reward/risk continuum provides a vantage view of the rewards that might be logically expected to accrue to manufacturers undertaking toll, contract and full-fledged manufacturing activities.²³⁶ The comparative analysis of risks for various kinds of manufacturing activities is provided as below:-

Table 16: Analysis of risk undertaken in different types of manufacturing activities

Type of Risk	Full-fledged Manufacturing	Contract Manufacturing	Toll Manufacturing
Raw Material Inventory	√	√	X
Finished Goods Inventory	√	X	X
Warranty / Product Liability	√	X	X
Market Risk	√	X	X
Customer Credit Risk	√	X	X
Scheduling Risk	√	√	X
Volume Risk	√	√	X
Asset Redundancy risk	√	√	X
Inflation risk	√	√	X

Where different manufacturing plants undertake different stages of the manufacturing or finishing and the packaging are carried out by the reseller, the situation become more complicated. It is important to conduct a comprehensive functional analysis in order to ascertain the correct transfer pricing method to be used in the benchmarking process. Therefore from the

²³⁶ Risk and Reward relationship is defined in Capital Asset Pricing Model (CAPM), which was developed in 1970s and is extensively used by the financial analyst. This model calculates the expected return based on risk differential.

above, it is evident that functional analysis for risk and reward expectation correlation is important for a proper benchmarking and setting a transfer pricing policy.

The importance of functional analysis was discussed in detail in one of the latest landmark judgment in the matter of *LG Electronics India (P.) LTD. v. ACIT*²³⁷

The commentary of OECD²³⁸ on Article 5 mention that fixed place of business should have fixed premises along with machinery or equipment. The expression "a fixed place" indicates some permanence. It is necessary that the business of the enterprise be carried on through a fixed place. A number of places are specified in various clauses and clause (I) includes provision of services by an enterprise within a contracting state through employees or other personnel.

Case Study 7: Reasons for avoiding subsequent Transfer Pricing Adjustments

The company selected for the case study was engaged in contract manufacturing in India. It would purchase semi-finished goods from its associated companies located in USA. The group allocated some cost related to IT, accounting, taxation etc.

The rate per unit was decided at the beginning of the financial year was based on the estimated sales and cost of next year. Based on that, the transfer price for the sales from India to US was finalised. At the end of the

²³⁷ 2014 (52) Taxmann.com (Trib) 240 (Delhi)

²³⁸ *Commentaries on the Articles of the Model Tax Convention*, (OECD) available at <http://www.oecd.org/berlin/publikationen/43324465.pdf> (Last accessed on June 20, 2015)

year, there was a "True-up" debit note ²³⁹charged by the holding company in US for services like management charges, financial support charges, etc. The following table is abstract from the financials of the selected company.

Table 17: Extracts from the financial accounts of the selected Company

Sales to U.S. @ \$100/- per unit	\$ 10,000,000
Cost including SG&A before "true-up"	\$ 8,000,000
Profit Before Tax	\$2,000,000 (i.e., 20% comparable)
True up Debit note	\$1,000,000
PBT after True up	\$1,000,000(i.e., 10% non comparable)
Arithmetic mean of comparable companies	16%
Profit Level Indicator	ROS

The issue was scrutinized in detail and the risk was analysed as below:

- a) There is a significant exposure with regard to customs valuation of goods since the true up can be considered as subsequent payment for the materials purchased from Group earlier. Hence, the customs duty paid on transaction value may be challenged and stiff penalties may be levied along-with penalty and interest.

- b) Since the profit earned by the company was not in the range of profit earned by the selected comparables, the company was in process of raising a debit note on the purchasing company for the additional cost which could result in issues with customs authority and VAT authorities in India along with issues at US with customs authorities. The Company decided to pay the differential customs duty for the additional value charged by the selling unit through debit note with

²³⁹ The difference between estimated cost and actual cost is ascertained and charged to the purchaser. The debit note for this purpose is known as "True-up" debit note.

interest and penalty, which resulted into higher cost for the purchasing unit.

Case Study 8: Impact on Working Capital and other Commercial Terms of the Business

Table 18: Extracts from the Profit & Loss of an Indian unit of US based MNC

Particulars/Year	2010	2011	2012	Average
Sales	100,000	300,000	500,000	300,000
Cost of goods sold	80,000	240,000	480,000	266,667
Operating Expenses	20,000	40,000	60,000	40,000
Operating Profit	0	20,000	(40,000)	(6,667)

- (i) The average mean of the operating profit for the comparable companies were in the range of \$20,000 to \$ 35,000. US subsidiaries' average profit was outside this range between years 2010 to 2012. Therefore the TPO decided to adjust the income upward for determining the correct arm's length pricing.
- (ii) To adjust the income, the TPO derived the profit by applying the profit to sales ratio of all the uncontrolled distributors for the years from 2010 to 2012. The average profit ratio so derived was used by the TPO to derive the profitability of the US sub.
- (iii) The average profit by applying the average mean of profit ratio for uncontrolled distributors was calculated as US\$ 15,000. Therefore,

the TPO proposed to add US\$ 54,000 to the income of the US subsidiary.

Another example will demonstrate the importance of various adjustments needed for working capital difference also:-

Table 19: Analysis of working capital impact on profitability

Particulars	Reference	Comparable Company	Tested Party
Sales	A	100	500
Operating Cost	B	90	400
Purchases	C	40	200
Cost of Goods Sold	D	50	200
Operating Profit	E=A-B	10	100
Operating Profit Margin (PLI)	F=E/A*100	10%	20%
Inventory***	G	10	100
Inventory adjustment	H=(100/500)- (10/100)*100*0.1	1	-
Capital adjusted operating margin	I	11	-
Adjusted Operating Profit		11%	

*** only inventory is used for testing the model

The analytical case studies helped the researcher to develop a suitable transfer pricing model and also helped to analyse the risks associated with

decisions/transaction with regard to transfer pricing if such model is not followed. Also it had helped to perform a risk assessment with regard to other applicable statutes which is discussed elsewhere in this study.

Further, the discussion on various court rulings has helped to finalise a pricing and documentation model which would help to reduce the litigations.

During the analysis of the business models of various companies²⁴⁰, it was revealed that improper transfer pricing strategy can also lead to non-fulfillment of economic objective of the company.

The case studies conducted during this study was helpful to analyse different scenarios, impact of the decisions, judiciary's approach and impact on overall profitability of the Company. The result and commentary is also provided in this chapter.

Landmark judgment with regard to importance of business model understanding

In the landmark case of *Morgan Stanley and Co.*, US²⁴¹, the importance of business models were discussed. The Company, incorporated in US, was engaged in financial advisory services, corporate lending and securities underwriting. There were various division within the Company to take care of various business. One of the group companies, MSAS, incorporated in India, was established as a shared service to manage the infrastructure functions of its global operations, including services such as IT support, account reconciliation and research.

²⁴⁰ Business Models has been discussed in various chapters in this study.

²⁴¹ 2006 152 Taxman 1

MSAS (the Indian Entity) entered into a service agreement with the holding Company. According to the agreement, MSAS agreed to develop computer software including customised electronic data or computer programmes or the various divisions of the applicant such as equity research, fixed income division, equity finance service divisions and investment banking divisions. It also agreed to provide research reports, data analysis, industry- and company-specific analysis, earning models of companies as an on-going process. To enable MSAS to provide those services, it was agreed between the trading parties that the holding company would send its staff to India for training and other similar activities.

It was agreed that the applicant Company will reimburse all the cost incurred by MSAS with an appropriate agreed mark-up, mutually agreed upon. It was decided that the staff deputed at MSAS would continue to be a staff of the applicant and their salaries etc will be directly paid by the applicant. MSA would reimburse the cost bore by the applicant company in this regard. TNNM was selected as the most appropriate, and operating profit margins was considered to be the profit level indicator in respect of the services rendered by MSAS to the applicant. MSAS charged 29% as mark-up under the agreement since the average margin earned by comparable companies providing similar services was worked out at 28.33 per cent

Under this agreement, MSAS used the brand name, trade name and computer hardware of M. The software developed by it was passed on to the M group. As per the agreement MSAS would have no right or interest in the products. Although AAR adjudicated that MSAS had a fixed place of business but there was no concluding evidence to show that the business of the applicant was carried on through the place of business of MSAS.

Due to the above facts, AAR didn't accepted the contention that the prevailing business model of MSAS amount to carrying on business by the trading partners through the fixed place of business of MSAS. AAR ruled that the main condition of carrying on business through a fixed place of business of MSAS, not being fulfilled, Article 5 (1) would not be attracted.

From the terms of agreement, it was clear that the employees of the applicant were deputed at MSAS for more than 90 days. The applicant's contention that the staff was working for the applicant was not accepted by the AAR. It had observed that even if the benefit of the services provided by the staff of the applicant will flow to the applicant, , they would be actively involved in the key managerial activities of MSAS. It follows that the ingredients of para (2)(1) of Article 5 are satisfied. Therefore, the AAR ruled that MSAS would constitute a PE.

This ruling is a landmark decision about the interpretation of provisions of Double Tax Avoidance Agreements pertaining to the concept of a permanent establishment. This judgment clear doubts about the nature of business profits that can be taxed in a contracting state.

In another landmark judgment on this issue, the decision of Delhi High Court in *DIT v. Galileo International INC*²⁴², to uphold the decision of ITAT delhi i about the applicability of the business connection as per Section 9 (1) (i) of the Income Tax Act, 1961. The tribunal in its earlier order²⁴³ observed that there are certain activities which need to be termed as business connection in the case of same company. The business connection has an uncertain meaning. Therefore, to decide whether there is business connection or not, the facts of each case need to be analysed. While deciding that the Income should accrue to Indian assessee, ITAT detailed the reason for such decision as below:-

- a. The travel agent (Interglobe Enterprises Limited, referred herein below as "Interglobe") were provided computer hardware and the connectivity by the Indian Assessee.
- b. Booking used to take place in India through the system provided by the assessee;
- c. Booking was the main function for earning the revenue;

²⁴² 2009 TIOL 161 HC- Del-IT

²⁴³ 2009 TIOL 488 ITAT-Del

In view of the above, the income generated from the booking made in India should accrued since arisen in India as per Section 5(2) of the Income Tax Act. As per this section, in case the majority of the business operations are carried out in India, the income generated from such operation would be deemed to accrue or arisen in India. In the given case after careful study, it was revealed that only 15% of the total required operation viz, booking was carried on in India. Therefore, after deduction of all the expenses of Interglobe, the ITAT held that since the Income attributable to the Indian establishment was lower than the agency commission paid to the entity, there were no further taxable income to be taxed in India.

As regards permanent establishment under DTAA, reference was made to Article 5(1) of DTAA which provides a definition of permanent establishment. A permanent establishment is a place which is used to generate income. The ITAT held that Galileo had a fixed place of business since the computers provided to the travel agents through which the bookings were carried on, can be termed as a business operation. Therefore, the justification of the ruling was that since the booking system was an integral part of the total operation, Galileo has a permanent establishment in India.

OECD points out that when fixing conditions in relevant controlled transactions, "the questions should be resolved by both the tax payers and tax administrations, by reference what an independent enterprise would have done in comparable circumstances. Associated enterprises facing the task of finding justifiable conditions for a transaction involving a commercial intangible (whether valuation is uncertain or highly certain) should try to find a solution that is reasonable for both the parties concerned from an economic point of view. They should also establish adequate documentation for the purpose defending it. In particular a written agreement which is carefully

complied with and accompanying documents substantially the underlying reasons will be helpful".

IMPORTANCE OF CORPORATE GOVERNANCE AND IMPACT OF OTHER STATUTES

Importance of independent business decision: After analyzing various transactions of MNCs, the researcher submits that the impact of independent decision of the unit in host country is important. It was observed that the losses sustained by an MNC were not as a result of direct transactions entered into with associated company. Instead, it was the result of decisions made at global level by the group which resulted in losses for the unit at host countries. The statement may be examined by analyzing the following example:-

Case Study 9: Business Decisions were influenced

The impugned company was involved in manufacturing and supply of semi-finished products to its associated company situated in the USA. The company would manufacture and sell products produced at its plant and worked as a distributor for products manufactured abroad by group companies. The company also obtained Information Technology services from associate companies. The unit in India was acquired by the Group in 2007. Prior to acquisition, the unit was selling these products to its customers. However, after acquisition, as a strategy the group decided to stop selling to the unit's erstwhile customers which included one of the competitor companies of the Group. This decision resulted in underutilization of the plant capacity. There was a plant in US controlled by the Group which would produce similar product. After ensuring that the plant in US is fully utilized, the group would instruct the unit in India to produce the balance quantity. This underutilization was not compensated by the group while

finalization of the transfer price although the unit after acquisition became a Toll manufacturer²⁴⁴ for the group.

The above decision was taken by the group although the unit was working as a separate legal entity and the decisions of Board are expected to be uninfluenced. However, it was observed that the Board had acted on the guidance from the group, which resulted into underutilization of the plant. Therefore it can be concluded that the management of the unit was not acting independently and the decisions of the unit was influenced. The Company sustained losses in first 2 years of incorporation. Since transaction value of the company with its associated companies was more than the threshold limit for referral to TPO, the company complied with all the requirements of Transfer Pricing rules.

Company adopted TNMM²⁴⁵ methodology which was profit based entrepreneurial approach²⁴⁶ and benchmarked its earning with eligible comparable and submitted its justification for losses. In its submission, it adjusted the different allowable adjustment and after adjustment, the earning of the company was within the range of comparable companies. In the first year, TPO accepted the submission and no adjustment were made to its disclosed profit. However, the same methodology was rejected by the TPO in the second year since the comparable selected by the company was unacceptable by the TPO and therefore based on the profitability of the companies selected by him for comparison, TPO ruled that an adjustment of profit should be made.

²⁴⁴ Toll manufacturing refers to an arrangement in which an entity processes raw materials or semi-finished products for another entity.

²⁴⁵ Transactional Net Margin Method.

²⁴⁶ *Infra* Chapter 1

The above situation proved that the scrutiny process is not stable and systematic to uncover the actual issue and root cause for the losses and therefore exchequer may lose revenue due to TPO's inconsistent rulings.

Case Study 10: Business decision was influenced which caused loss to minority shareholders

Impact of business decision was also observed in one of the case where the Company had 4 business units in India who were net importers. This group also had a shared service center²⁴⁷ in India. The shared service center was in SEZ due to nature of their business. The regional treasury department of the Group decided that Company will follow country specific hedging policy²⁴⁸. Due to this decision, the business units would sustain losses and the shared service center would earn profits. However this decision resulted into revenue loss to the exchequer as the business units became non-taxable companies. Also on further analysis, it was observed that the business unit was not fully controlled by the Group and there were some minority shareholders²⁴⁹. It was observed that due to continuous losses, the market value of shares of this business unit was reducing. This needs to be investigated whether this decision was aimed to target 'buyback' of minority shareholding.²⁵⁰

²⁴⁷ Shared Service Centers are established by the Companies to provide various services to its associated enterprises to standardize the transaction processes and reduce the costs of respective units.

²⁴⁸ There were 9 separate legal entities operating in India, which were controlled by the group. Few of these entities were net importers and rest was net exporters. Couple of the entities, which was a net exporter, was enjoying tax holidays. The group decided to hedge consolidated foreign currency exposure on country level and not at unit level.

²⁴⁹ The group holding was 97.4% and minority shareholding was 2.6%.

²⁵⁰ Since the company was a net importer (Import was higher than export), the company sustained losses due to depreciation of Indian Rupee. This has resulted into losses being sustained by the Company. The Company offered a buy-back of the minority shareholding in earlier year. The valuation was done based on the future earning potential based on the current profitability. Since the current profitability was lower, the future earning potential was become lower. Also higher losses may force minority shareholders to sell their holdings at the price offered by the company considering the

Case Study 11: Allocation of cost by Group and applicability of section 188 of the Companies Act, 2013

The selected company was engaged in contract manufacturing in India. It would purchase semi-finished goods from its associated companies located in USA. The group would allocate some cost related to IT, accounting, taxation etc. The rate per unit was decided at the beginning of the year considering the planning parameters for next year. Based on that, the unit in India used to charge US unit for its sale. At the end of the year, a debit note raised by the holding company in US for services like management charges, financial support charges etc. which had resulted into erosion of profit for the unit in India. The following table is an abstract from the financials of the aforesaid company.

Table 20: Excerpts from the financials of an Indian unit of an MNC

Sales to US @ \$100/- per unit	\$ 10,000,000
Cost including Selling, General & Administrative expenses before "true-up"	\$ 8,000,000
PBT	\$2,000,000 (i.e., 20% comparable)
Debit note from Group for allocation of support cost	\$1,000,000
PBT after True up	\$1,000,000(i.e., 10% non-comparable)
Arithmetic mean of comparable companies	16%
PLI	ROS

future earning potential. Hence this action may be termed as "squeezing out" the minority shareholders.

Since Board of Directors were responsible for approving all inter-company transactions, the need is to scrutinize whether the decision of the Board was influenced while approving intercompany transactions especially the true-up debit note as mentioned above, which was not backed up by the business rationale. Section 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 debit note which is a related party transaction may create conflict of interest and may not be aimed at best interest of the company, especially for minority shareholders, if the business justification for accepting this debit note is established. The impact of corporate governance on related party transactions is discussed in detail in Chapter 3 of this study. This particular related party transaction may be aimed to siphon funds out of the company to another company, which is a related party. These transactions can be also considered as opportunity that is lost to a related party to the detriment to the shareholders and interest of the company. Thus, these conflicts of interests are inherently linked to the governance structure of a company, which can either enhance or limit the board's effectiveness. The board is responsible for reviewing and guiding corporate strategy and for effectively monitoring management, and is accountable to the company and its shareholders.

IMPORTANCE OF UNDERSTANDING VALUE ADDITION

For a complex nature of inter-group transaction involving purchase of material or services from associated companies for different activities, it is important to identify the economic value addition at every stage of the manufacturing process for adopting a correct transfer pricing policy. The

nature of activities carried out by a unit in host country can be categorized as below:-

- a) As a Distributor and Warranty HUB
- b) As a Distributor only with no cost for Product Warranty
- c) As a Distributor but no inventory cost (High Sea Sales)
- d) As a commission agent
- e) As a contract manufacturer
- f) Manufacturing
- g) Contract R&D
- h) Service Provider

In each of the above activities, the value addition is different in host country and therefore transfer price for the group companies should be different. However, the researcher has observed that in most of the cases studied by him,²⁵¹ the transfer price was same irrespective of the nature of activities performed. The following example will help to understand the importance of functional analysis for adoption of a correct transfer pricing policy.

PRICING CALCULATION BASED ON ECONOMIC VALUE ADDITION

Based on various court rulings²⁵², need of business model based pricing methodology²⁵³ and the applicability of various methodology²⁵⁴, the researcher recommends the indicative arm's length pricing comparability methodology in the table appended below. This table is inserted to indicate the necessity of business model identification for arm's length pricing comparability purpose.

²⁵¹ Case studies provided in this Chapter and other chapters in this paper. Also reference is drawn from tribunal ruling in the matter of LG Electronics India (P) Ltd v ACIT – 2014 (52) Taxmann.com (Trib) 240 (Delhi)

²⁵² *Ibid*

²⁵³ As discussed in various case studies narrated in this chapter

²⁵⁴ *Infra*, Chapter 1

Table 21: Indicate list of inter-group activities and methodology suggested for arm's length pricing calculation

Transactions	Suggested Methods				
	Comparable Uncontrolled Price Method	Resale Price Method	Cost Plus Method	Transactional Net Margin Method	Profit Split Method
Commodities/Oil	√				
Payment of Interest	√				
Distribution of goods		√			
Provision of Service			√		
Contract Manufacturing			√		
Manufacturing			√	√	
Payment of Royalty	√				
Multiple transactions involving intangibles					√
Management Charges	Cost plus method is applicable since without proof of service, the charges will be disallowed.				
Sale of Shares, intangibles	No Specific method, Valuation report can be relied upon				

Transfer Price changed after proper business analysis

Table 22: Financials before functional and Business Analysis were done

Chemical Company Limited Profit & loss for the FY 20XX	
Particulars	Amount in INR
Sales	442,714,818
Agency Commission	17,923,175
Material Cost	(131,649,341)
Personnel Expenses	(71,088,531)
Operating & Other Expenses	(265,120,157)
Depreciation & Amortisation	(225,739,242)
Financial Expenses	(870,914)
Profit (loss) for the year	(233,830,391)

Other Facts: Sales to associated enterprise were approximately 85% of the total sales. Agency Commission was earned from associated enterprises for marketing activities done in India. Operating expenses include approximately 50MINR which was paid to the Group as support charges for environment due diligence done by the Group. The Company acquired another company during the year and paid prices for intangibles like Patent and Copyrights and also the difference between the acquisition value and asset value was taken to balance sheet as goodwill. There was a significant charges paid to ROC for various fees during the year.

The net margin for comparable companies for operating profit on sales was 6%. The comparable was selected from the results available in Prowess and Capitaline database. The initial reading of the financials would suggest that intercompany transactions contributed to the significant losses sustained by the local unit and therefore *prima facie* may be concluded as a case of transfer pricing abuse. However, a detailed analysis of the profit and loss account with appropriate adjustments revealed the results as provided in Table 23.

The adjustment for the exceptional items (as mentioned in the paragraph detailing the facts of this case in the earlier paragraph) was needed for the purpose of comparison. One of the significant observations was that the Group had acquired this unit and therefore a significant amount of intangibles

in form of goodwill, trademark, etc. are appearing in the balance sheet. The brand and patent was also purchased and not created. Consequently, there was a significant amount of amortization expenses charged to Profit & Loss account which needed to be adjusted for any comparison. The fee paid to RoC was non-operational expense for the comparability purpose, which should be excluded for comparison with other comparable Companies. Due diligence expense paid to Group was also exceptional for the year and

Table 23: Segmental P/L and Adjustments

Segmental P/L and adjustments for the year 2006-07

Statistical Information	Sulfone	UPP	Monomer
Capacity Utilisation	56%	0%	69%
Installed Capacity (TON)	1,620	84	1,440
Utilised Capacity	904		1,662
Production	904967		500000
Ratio for allocation of indirect cost (based on sales)	81%		19%

(72.01)

Particulars	Basis for Allocation	Sulfone	UPP	Monomer	Total	Agency Business	Total
Sales		356,858,816	6,982,507	78,873,295	442,714,618	6,710,278	451,424,896
Raw Material Consumed	Actual	(34,830,264)	(4,461,649)	(100,817,130)	(140,109,042)		(140,109,042)
Adjustment for Captive Consumption	Captive	(58,531,134)		58,531,134			
WIP	Actual			10,973,782	10,973,782		10,973,782
Direct Salary	Net Prod	(15,777,938)		(3,700,998)	(19,478,936)	(2,812,211)	(22,291,147)
Maintenance	Asset	(7,481,696)	(931,037)	(2,512,888)	(10,925,620)		(10,925,620)
Adjustment for Captive Consumption	Captive	(1,633,377)		1,633,377			
Service Department Salary Allocated	Net Prod	(11,991,799)		(2,812,891)	(14,804,690)		(14,804,690)
Stores Consumed	Net Prod	(7,242,577)		(1,898,876)	(9,141,453)		(9,141,453)
Fuel Consumed	Net Prod	(61,529,868)		(14,432,932)	(75,962,800)		(75,962,800)
Material Handling/Freight Outwards	Net Prod	(8,778,547)		(1,950,394)	(10,747,531)		(10,747,531)
Repairs	Asset	(4,909,187)	(610,162)	(1,646,840)	(7,166,190)		(7,166,190)
Adjustment for Captive Consumption	Captive	(1,070,448)		1,070,448			
Waste Disposal	Actual	(5,621,324)			(5,621,324)		(5,621,324)
Contract Manpower	Net Prod	(5,846,846)		(1,371,436)	(7,218,082)		(7,218,082)
Quality Cost	Actual	(3,071,597)			(3,071,597)	(2,204,107)	(5,275,704)
Other Miscellaneous Travelling etc	Actual	(15,771,963)			(15,771,963)		(15,771,963)
Depreciation	Actual	(62,904,506)	(7,827,960)	(21,127,825)	(91,860,291)		(91,860,291)
Gross Contribution		118,353,564	(6,848,300)	70,886,002	132,391,266	3,693,960	136,085,226
%		33%	98%	26%	30%	42%	
Overhead							
Administrative Salary	Sales	(18,593,668)	(363,815)	(4,109,591)			(23,067,074)
Utility Cost							(4,999,550)
Depreciation on other Misc Assets	Deprec	(4,775,400)	(694,260)	(1,603,920)			(6,973,580)
Legal & Professional Fee	Actual	(748,674)					(748,674)
Rent for Administrative Building	Actual	(5,053,417)					(5,053,417)
Insurance	Deprec	(5,005,010)	(622,833)	(1,681,040)			(7,308,882)
Miscellaneous Other indirect expenses	Allocation	(12,641,883)	(29,497,728)				(42,139,611)
Other Income							6,407,861
Financial Expenses							(870,914)
Adjusted Profit or loss		71,535,511	(37,926,936)	13,491,451		3,693,960	51,333,383
Per Unit Rate		79		27			
Total Cost		(374,538,009)		(66,524,935)			
Per Unit Cost of Production		(414)		(133)			
Exceptional Item							
Depreciation on Intangibles							(126,905,371)
RoC Expenses							(23,421,839)
Due Diligence Expenses							(44,476,769)
Adjustment for Lower Capacity							(60,357,795)
Net Profit or loss							(293,830,391)

needed to be excluded for comparability purpose. Further, it was noted that the due diligence expenses paid to an associated enterprise, which was a reimbursement for the payment made by that company on behalf of the local company.

The Income Statement of one engineering product manufacturing company is given in Table below:

Table 24: Income Statement of Engineering Product Manufacturing Company.

Particulars	Reference	Fig in Rs'000
Sales	A	2,214,745
Misc. Income	B	11,194
Revenue	C=A+B	2,225,939
Raw Material Consumed	D	1,571,114
Inter-Company Transaction Value	Reference only	709,071
Personnel Expenses	E	237,133
Operating & Other Expenses	F	463,230
Depreciation	G	53,248
Total Cost	H=D+E+F+G	2,324,726
Profit Before Tax	I=C-H	(98,786)
OP/Sales		-4.4%

Since the Inter-company transaction of the Company was higher than threshold limit, the matter was referred to TPO. The company adopted TNMM as transfer pricing methodology to prove arm's length pricing and benchmarked with comparable companies which were also sustaining losses. The TPO rejected the selected companies for comparison since

majority of them were loss-making entities. He selected some comparable companies which had positive operative margins. Applying the median profit percentage of the selected comparable, which was 3.5% on sales, the TPO assessed the company profit at 77.9 M INR. Therefore, adding 176 M INR to the profit of the company. The researcher had analysed the financials and adopted a transaction based approach to re-analyze the root cause of the losses. The results were as below in Table 25.

At this stage, the financials revealed that the operating profit consisted of some extra-ordinary items and financial expenses which should not be considered for the purpose of benchmarking. At this stage, the PLI is changed for the company from negative (4.4%) to negative (1.75%).

Yet, from an overall perspective, the profitability was not comparable to the benchmarking companies. A simple reading of the financials at this stage would have suggested for adjustment of 116 M INR.

The researcher then proceeded for further analysis and breakdown of financials based on their various activities. On further analysis of their functions, the business could be bifurcated into following activities based on risk and reward expectation:

- a) Distribution activities
- b) Manufacturing
 - a. Toll Manufacturing for one OEM
 - b. Contract Manufacturing for one OEM
 - c. Full-fledged manufacturing where no assets being used
(Subcontracting model)
- c) Management Services provided to group companies

TABLE 25: Financials with Bifurcated Segments

Particulars	Basis of allocation	Distribution Total			Manufacturing Total			Total
		AE	Non-AE	Total	AE	Non-AE	Total	
Sales		698,788	27,820	726,608	926,863	561,275	1,478,162	2,204,770
Scrap Sales	Sales	-	-	-	1,361	824	2,185	2,185
Income from services	Actual	-	-	-	-	9,975	9,975	9,975
Operating income (Sales)		698,788	27,820	726,608	928,224	562,099	1,490,322	2,216,930
Consumption	Actual	559,642	28,655	588,297	597,715	385,103	982,818	1,571,114
AE Transaction(Ref)		559,642	-	559,642	149,429	-	149,429	709,071
Personnel expenses	Actual	-	-	-	33,103	18,899	52,002	52,002
Personnel expenses	Sales	58,412	2,325	60,737	77,477	46,917	124,394	185,131
Personnel expenses		58,412	2,325	60,737	110,580	65,816	176,396	237,133
Operating and other expenses	Actual	-	-	-	-	-	-	-
Operating and other expenses	mfg sales	-	-	-	143,929	67,469	211,398	211,398
Operating and other expenses	Sales	57,689	2,297	59,986	76,518	46,336	122,854	182,840
Operating and other expenses		57,689	2,297	59,986	220,447	113,805	334,252	394,238

Depreciation amortization	/ Actual	-	-	-	27,779	16,756	44,534	44,534
Depreciation amortization	/ Sales	2,749	109	2,859	3,647	2,208	5,855	8,714
Depreciation amortization	/	2,749	109	2,859	31,425	18,964	50,389	53,248
OP/Sales		2.90%	-20.01%	2.03%	-3.44%	-3.84%	-3.59%	-1.75%
Other income								9,009
Other expenses								
- Exchange difference (net)								(26,907)
- increase /decrease in excise								1,425
- Wealth tax								(579)
- Bad debts								(978)
Financial expenses								(41,953)

At this stage, the researcher analysed the distribution activities since no further breakdown of that activities were needed. We observed that the company was earning 2.90% for all goods imported from associated enterprise (AE), whereas, earned negative 20.1% on goods imported from third party.

On further analysis on the risk and reward, it was understood that these goods irrespective of AE goods or third party goods, competitors have started local manufacturing and therefore was not exposed to Fx volatility which has significantly reduced the margin of the company.

At this stage also, the internal comparable suggested that company is maintaining the expected profitability. However, to create a strong case, the financial was planned to be compared with external comparables – Independent Distributor.

On further analysis, it was revealed that the company has paid royalty @ 1% on use of business system and 1% on trademark. However, no royalty was paid/payable on the imported goods. Therefore, the researcher recalculated the financials as per stage 2 with royalty treated differently as provided in Table 26.

At this stage, the OP/Profit of distribution segment for AE transaction is adjusted to 3.93% vs. operating profit / sales of third party distribution segment is now 18.99%.

The researcher analysed the distribution segment for intergroup products and observed that the distribution can be bifurcated into 2 sub-segments. A) Distribution with Inventory, customer credit and Fx risk. B) Distribution without inventory, customer credit and Fx risk. We will ignore third party products as provided in Table 27.

Particulars	Basis of allocation	Distribution Total			Manufacturing Total			Total
		AE	Non-AE	Total	AE	Non-AE	Total	
Sales		698,788	27,820	726,608	926,863	551,300	1,478,162	2,204,770
Scrap Sales	Sales	-	-	-	1,361	824	2,185	2,185
Income from services	Sales	-	-	-	-	9,975	9,975	9,975
Excess liability written back	Sales	-	-	-	-	-	-	-
Operating income ('Sales')		698,788	27,820	726,608	928,224	562,098	1,490,322	2,216,930
Consumption	Actual	559,642	28,655	588,297	597,715	385,103	982,818	1,571,114
<i>International transactions AE</i>		<i>559,642</i>	<i>-</i>	<i>559,642</i>	<i>149,429</i>	<i>-</i>	<i>149,429</i>	<i>709,071</i>
Personnel expenses	Actual	-	-	-	33,103	18,899	52,002	52,002
Personnel expenses	Sales	58,412	2,325	60,737	77,477	46,917	124,394	185,131
Personnel expenses		58,412	2,325	60,737	110,580	65,816	176,396	237,133
Operating and other expenses	mfg sales	-	-	-	143,929	67,469	211,398	211,398
Operating and other expenses	Sales	50,545	2,012	52,557	67,042	40,242	107,284	159,840
Royalty	mfg sales	-	-	-	14,325	8,675	23,000	23,000
Operating and other expenses		50,545	2,012	52,557	225,296	116,386	341,682	394,238
Depreciation / amortization	Actual	-	-	-	27,779	16,756	44,534	44,534
Depreciation / amortization	Sales	2,749	109	2,859	3,647	2,208	5,855	8,714
Depreciation /							50,389	

amortization		2,749	109	2,859	31,425	18,964		53,248
Underutilization Impact	Actual	-	-	-	-	-	-	-
Operating costs		671,348	33,102	704,450	965,016	586,269	1,551,285	2,255,734
Adjusted Operating Profit ("OP")		27,440	(5,282)	22,158	(36,792)	(24,170)	(60,963)	(38,804)
OP/Sales		3.93%	-18.99%	3.05%	-3.96%	-4.30%	-4.09%	-1.75%
Other income								9,009
Underutilization impact								-
Other expenses								
- Exchange difference (net)								(26,907)
- increase /decrease In excise								1,425
- Wealth tax								(579)
- Bad debts								(978)
Financial expenses								(41,953)
Profit before tax								(98,787)

Table 26: Financials with Royalty

Table 27: Distribution Segments for Inter-group Products

Particulars	Balance Sheet	Type A	Type B	Total	Comparable Companies (Type A)
Sales		448,788	250,000	698,788	1,245,345
Consumption		322,142	237,500	559,642	915,329
% on Sales		72%	95%	80%	74%
Operating Cost					
Personnel Cost		55,400	3,012	58,412	124,535
Other Admin Cost		47,948	2,597	50,545	136,988
Depreciation		2,749	-	2,749	
Total Operating Cost		106,097	5,609	111,706	261,522
Operating Profit		20,549	6,891	27,440	68,494
Inventory	105,000				560,405
Debtors	114,500				272,952
Import %	100%				70%
OP/Profit		5%	3%	4%	5.5%
Adjustment as below table		10,893			
Capital adjusted Profit		31,442			
Adjusted Profit/Sales		7.0%			
Median of Comparable Companies		5.5%	3%		

Table 28: showing adjustments

Particulars	INR	Remarks
Inventory Adjustment	5,543	Impact of Inventory level adjustment calculated to make the comparable company at the same level
Debtors Adjustmnet	(449)	Impact of Debtors level adjustment calculated to make the comparable company at the same level
FX Adjustment (INR depreciation by 6%)	5,799	Fx impact due to level of import component adjusted
Total Adjustment	10,893	

From the above calculation, the profit for both categories of distribution was calculated at either above or at the same level of the comparable company. The manufacturing segment was now further bifurcated as below:-

Table 29: Manufacturing Segment

Particulars	3rd Party	Inter-Company Purchase/Sales				Total
	Product 1	Product 1	Product 2	Product 3	Product 4	
Sales	561,275	10,136	417,598	390,506	108,623	1,488,137
Consumption	385,103	6,791	200,610	340,066	50,248	982,818
% on Sales	69%	67%	48%	87%	46%	66%
Imports	38,510	679	50,152	85,017	14,260	149,429
% on Consumption	10%	10%	25%	25%	28%	15%
Personnel Expenses	65,816	1,834	55,288	42,471	10,987	176,396
Operating & Other Exp (Fixed Cost 55%)	116,742	1,991	95,703	77,998	49,604	342,038
Depreciation	18,964	343	23,247	6,013	1,822	50,389
Operating Cost	201,522	4,168	174,238	126,482	62,413	568,823
Operating Profit	(25,350)	(823)	42,751	(76,042)	(4,038)	(63,503)
OP Profit/Sales	-5%	-8%	10%	-19%	-4%	-4%
Utilisation Rate	50%	50%	80%	50%	50%	
Comparable Utilisation	80%	80%	80%	80%	80%	
Depreciation as % of Sales	3%	3%	6%	2%	2%	
Comparable Depreciation rate	3%	3%	3%	3%	3%	
DSO	40	30	75	45	90	
Comparable DSO	50	50	50	50	50	
DOH	30	30	55	25	120	
Comparable DOH	50	50	50	50	50	

Type of Manufacturing	Full Fledged	Full Fledged	Full Fledged	Toll	Contract	
IP rights	No	No	Yes	Customer	No	
Adjustments:						
Underutilisation on Fixed Cost	33,251	688	-	20,870	10,298	65,107
FX (Normal -10%)	-	-	30,091	51,010	9,235	90,336
Asset Employed adjustment	-	(0)	(9,137)	7,181	1,848	(109)
Adjustment for DSO	4,827	183	(14,862)	691	(6,397)	(15,559)
Adjustment for DOH	6,623	123	(1,428)	3,009	(5,179)	3,148
Total Adjustment	44,701	993	4,664	82,760	9,805	142,923
Capital adjusted profit	19,351	170	47,415	6,717	5,767	79,420
Operating Profit/Sales	3.4%	1.7%	11.4%	1.7%	5.3%	5.3%
PLI	ROS	ROS	ROS	Cost Plus	ROA	
Benchmark Median	Not Applicable					5.0%

From the above analysis, it was concluded that the manufacturing segment was earning an operating profit which was within the range of comparable companies.

Case Study 14: Manufacturing

Facts: Two companies were selected for this case study, viz., a) Company 'A' which is a manufacturer and distributor Consumer Durables and b) Company "B" which is a manufacturer and distributor of Hydraulics Components. The facts and background for both companies were similar, which is listed below:-.

- i. The Company manufactures consumer durable products and sells in the Indian market
- ii. It also imports finished products from its associated enterprises and acts as a distributor for those products.
- iii. The company has shown two segments Manufacturing and Distribution and tested the profitability of both segments separately for proving arm's length pricing.

On scrutiny, it was revealed that both companies made perpetual losses from the local operation. Technical know-how support was provided by the Group. During scrutiny of the inter-company transactions, the following transactions were uncovered:

- a) Royalty payment was made for technical knowhow for company "A" and for trade Mark and Business System for company "B". Royalty was paid as a percentage of sales.
- b) Components purchased from its overseas associated enterprises either for distribution or semi-fished goods for use in manufacturing of finished goods.
- c) Amount paid for obtaining management services from Associated Enterprises
- d) Amount paid for Information Technology and accounting shared services support received from associated companies.

The researcher observed that royalty was included in input cost calculation.
TPO's Findings –

- 1) Reasons for higher purchase price of components from the AE not substantiated and also no comparable were produced
- 2) Merely stating that the cost of production is higher for overseas entities and not providing comparable data could not be accepted.
- 3) The assessee had not provided cost details of the AE to test their profitability for verifying reasonableness.
- 4) CUP may be applied using future domestic prices of imported components, after discounting them for inflation.

TPO's Stand – Royalty

1. Technical know-how procured should benefit the company by increasing its profitability of marketability.
2. The government approval for royalty payment does not prove the arm's length nature of transactions with AEs.
3. Royalty payment is not justified in case of perpetual loss-making companies.

Research Findings: In lieu of conventional profit based approach, the researcher applied transactional risk and reward based approach. The observations are listed below:-

Company was operating in buyer's market with strong competitors' presence. Therefore pricing was set @ Standard Cost + 8% margin. SG&A was approx. 9% on sales value which includes royalty of 2% on sales. Cash conversion cycle

was 120 days and payment term for associated companies was ex-works²⁵⁵ 60 days. The working capital loan was extended by a related company @ 9% interest which is calculated as 2% of the Sales. Due to fluctuation in foreign exchange, the loss was increased by another 3%. The total loss was 5% on sales.

The company pleaded that mainly foreign exchange fluctuation, additional cost and lower price realization for penetration into new market, higher conversion cost and stiff competition had contributed to the loss of the company. Analysis was done encompassing independent business decision, functional analysis and the observations were as below:-

- a) Royalty on business system included in SG&A was not independent business decision as no benefits could be quantified from this royalty payment and hence 1% loss is reduced
- b) SG&A includes management allocation of 2% from associated companies when all the management decisions and day-to-day control was with employees and managers of the local company. It was recommended that no support charges in similar nature should be billed unless specific services are received.
- c) The local management was also extending support to other business of the group and hence 5% commission was proposed on other entity which resulted in 1% additional income for the business.
- d) Service department was also providing services for the distribution segment alongwith warranty support which resulted in higher cost for

²⁵⁵ Ex-works is an International Commercial (INCO) terms which means the ownership of the goods sold is transferred at the plant of the seller. The risk is transferred at the same time

manufacturing segment. After warranty cost was billed to source plant for distribution segment, loss was reduced by another 1%

- e) Negotiation with associated enterprises done for payment terms and it was changed to reduce the cash conversion cycle to 50 days which resulted in reduction of working capital requirement and hence interest was reduced by 1%.
- f) Negotiation with associated enterprises was done on principal to principal basis and since the local company was undertaking inventory risk, product risk and market risk, it was decided that mark-up should be only 10% of the product sold. This had resulted in reduction of input cost by 2%.
- g) Due to strict RBI guidelines for hedging²⁵⁶, company decided to introduce India specific hedging policy whereby the service company's (a separate legal entity under SEZ) income was used for hedging the net exposure for the country. As a result, the company was earning profit in that SEZ unit which was not taxable and this entity in India was sustaining loss. When the hedging was bifurcated, the company started covering the loss from FX which resulted in increase in profit.

The result of above has turned around the company's financial health and 5% loss was converted into 6% profit. This case study revealed the importance of independent business decisions and the impact of change in approach towards adoption of Transfer Pricing policies.

²⁵⁶ Master Circular on Risk Management is available at <https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=5789&Mode=0#a2>

Case Study 15 – Distribution

Background: The selected company was a risk bearing distributor²⁵⁷ of the finished products produced by its associated enterprises. The company was also working as a warranty hub in India for all overseas associated companies. The company sustained losses in the financial year which was selected for scrutiny. The transactions with associated enterprises as listed below were reported in accountant's report:-

- a) Import of finished goods for distribution in Indian market
- b) Reimbursement of marketing expenses from AE

To benchmark the profits for its distribution activities in order to prove the appropriateness of arm's length principle, the company selected Resale Price Method and the PLI selected was Gross Profit/ Sales. Due to lack of similar comparable companies in the same activity under same conditions, companies dealing in consumer products were selected as comparables.

TPO's Contentions – Applicability of RPM vs. TNMM

- i. The TPO argued that comparables have significant functional and product dissimilarity vis-à-vis the taxpayer company.
- ii. Gross Profit Margins vary widely across different product categories. Hence distributors selling specific product needs to be selected for comparability purpose
- iii. Differences in functions performed, especially in marketing and after sales warranty, have significant impact on Gross Profits. Therefore, functional analysis needs to be done in detail.

²⁵⁷ A risk bearing distributors assumes all types of business risk

- iv. The TPO observed that selected comparables are acting as channel distributors, with lesser margins (as their functions are limited), whereas the assessee is an exclusive distributor performing additional functions, assuming more risks and should have earned significantly higher margins.

Assessee's Arguments: Comparables selected were engaged in distribution of consumer products, and broadly undertook similar functions as the assessee. The assessee company further submitted that due to the nature of business, RPM is the best method for distributors.

TPO's Findings – RPM vs. TNMM

- i. Although RPM is an appropriate method for distributors, the differences between the assessee and the comparables should not be significant in terms of functions performed, risks assumed and product similarity.
- ii. The scope and intensity of operations of the comparables and the company should be compared thoroughly.

TPO's Conclusion: RPM rejected, TNMM selected to determine the arm's length price of imports.

Research Finding: The TPO erred in rejecting adoption of RPM for arm's length pricing since this is an acceptable methodology under Transfer pricing regulation in India. The TPO could have selected alternate comparable for benchmarking. Besides the above, the researcher analysed the *modus operandi* of the company and suggested the following to improve the comparability of the company in the context of Transfer Pricing assessments:-

- a) Company was distributor of different hydraulics components manufactured by the associated enterprises. After-sales-service was responsibility of the Company. Credit risk, exchange risk, inventory risk was borne by the company. Therefore, adjustments for these risks should be considered.
- b) On detailed customer wise scrutiny of the margin, it was revealed that 60% of the products were sold by the company @ 5-6% gross margin. The company had a cash conversion cycle of approx 130 days and payment term to associated enterprises was 60 days ex-works. This has resulted in higher working capital requirement which was funded by the group companies @ 9% interest.
- c) Product failure used to be borne by the company which was approximately 2% of the sales value and resulted in loss for the company.
- d) In case of rejection of material, the local company used to bear all logistic and local tax impact.
- e) After proper risk adjustment and transfer of warranty cost and logistic cost for rejection and re-negotiation of credit terms which resulted into lower working capital requirement, the profitability of the company increased.

Case Study 16 – Contract Manufacturing

Background: Company was engaged in manufacturing of semi-finished goods for AEs located in US which used to sell finished goods to all over the world. Company was also providing marketing services to other AEs and was reimbursed @ 3% commission on sales of the AEs. Company had an R&D wing which used to act as a contract R&D center for the Group.

Company was acquired by the US entity from an Indian Company. The pricing was fixed with US company for the contract manufacturing @ Total Cost + 12% markup. Payment term was 30 days ex-factory.²⁵⁸ The company was sustaining continuous losses. The company submitted under-utilisation as main reason for loss. In the first year of operation, TPO allowed the adjustment for under-utilisation and did not make any adjustment.

Research Findings: On detailed analysis of the financials, it was observed that:-

- a) Prior to takeover, company had two customers who used to purchase approx. 100% of the manufactured goods. After takeover since the company became exclusive contract manufacturer, sale was not made to these customers.
- b) Prices to the third party customers were higher than sale made to associated enterprise. Company's contention was that due to confirmed volume and lower credit risk from AE, the price was lower. Price mechanism was Cost Plus. However cost like R&D and under-utilisation was now added to the costing.
- c) There was a manufacturing facility at US which used to produce similar products. However since fixed cost was higher, the company decided to run its US facility @ 100% and Indian facility for the balance requirement. However cost was direct cost and not adjusted for unutilised capacity.

²⁵⁸ Ex-works is an International Commercial (INCO) terms which means the ownership of the goods sold is transferred at the plant of the seller. The risk is transferred at the same time

- d) Company used to provide R&D facility for US entity which used to produce finished goods. This was termed as after-sales support. Therefore, it was observed that cost should be included in costing of the product.
- e) Marketing Manager who was responsible for marketing for other entities in India was also the Managing Director of the company and hence cost was also added for the costing of the product.

The researcher observed that due to complexity of the transaction and without a systematic approach for Transfer Pricing scrutiny, the TPO failed to uncover the root cause of the losses. The researcher further observed that the prices charged to AEs for different services were underpriced and business decisions were influenced. Therefore, the exchequer sustained losses due to underpricing. Hence, this was a clear case of Transfer Pricing abuse.

Case Study 17 – Erection and Commissioning

Background: The selected companies were established its India operation in the calendar year 2000 wherein these companies mainly used to undertake installation and commissioning services for their clients with the components directly imported by their customers from associated enterprises of the selected company which were located overseas. Installation kits used to be procured locally. These local units would procure tools for installation and commissioning from overseas associated enterprises which was approx. 10% of their total purchase value. No other transactions was entered into with the associated entities.

These companies sustained continuous losses. Since transactions with associated enterprises were lower than the threshold limit for Transfer Pricing scrutiny, there was no transfer pricing audit referred by the assessing officers.

In one of the subsequent assessments, assessing officer referred the company to TPO for detailed scrutiny. TPO after scrutiny, ruled that these companies should earn at least 5% profit, which was calculated based on the profit margin of the comparables selected for the scrutiny. However since there was no associated enterprise transaction, the TPO recommended to AO to perform a detailed scrutiny on the local transaction and to make a profit adjustment to the tune of 22 crores. However since the recorded transaction with the associated enterprises was lower than 22 crore, the Chief Commissioner of Income Tax, disallowed the recommendation and reduced the adjustment by 20 crores.

On detailed analysis of the financials, the researcher observed that:-

- a) The installation and commissioning services was undertaken by these companies only for the equipment directly purchased from their associated enterprises by the customers. However, the local customers negotiated the total purchase price with the local unit. The bifurcation between equipment cost and installation charges used to be done by local unit based on some assumptive formula. The formula was prepared keeping in mind that the maximum value should be transferred to the component selling unit. The local entity was involved in finalising and concluding contract on behalf of their associated enterprises. Therefore, Section 9 would have been applied to these companies. However in absence of evidence and detailed understanding of the business, this was never evaluated by the AO.

- b) The local unit would provide after-sales support. Therefore, any parts needed to be replaced during the warranty period, the local companies would procure at their expense even if the original component was sold by the overseas associated enterprise. Thus, the warranty risk was undertaken by the local unit.
- c) The pricing bifurcation was done by the local company without independent costing of their quoted services. It was always residual of the total price recovered less amount to be paid to the AE selling the components.
- d) Company employed several service engineers who were providing after-sales service to the customers for the products sold by its AEs without any charges since the warranty risk was borne by the local unit.

Therefore, it was concluded by the researcher that although there was no direct transfer of profits made by the local unit, it was providing various services to the overseas AEs without any price. Therefore, the costs incurred by the local unit did not have a matching income, which attributed to the losses.

Case Study 18 – Service provider

TPO's Contentions – Value Chain :During assessment proceeding, TPO observed that the comparables chosen for proving appropriateness of arm's length pricing would provide low end software development/ coding services, whereas the assessee would provide considerably high end/ design services. The selection process of comparables adopted by assessee does not reflect an attempt to compare functional specialization of the assessee either qualitatively or quantitatively. The TPO further observed that the assessee's operations

entailed highly skilled personnel and high-tech operational platforms than that of the selected comparables. TPO came out with his own set of comparables using fresh search criteria, taking into account value addition – 20% mark-up.

TPO's Stand – Value Chain: TPO rules that the markup earned by the assessee does not commensurate with the nature/level of services provided. Risk borne by the assessee was adjusted on *ad hoc* basis in the absence of quantification of risk adjustment by assessee.

TPO's Conclusion: In light with the above arm's length mark-up was determined by the TPO as 18%

Observation by the Researcher: The researcher observed in this case that high value services need to be carefully analyzed for functional and risk analysis. Value chain analysis should be a core part of the comparable/economic analysis. It is critical to bring out the group's complete value chain and the activities undertaken by the Indian entity. The researcher submits that claims for adjustments needed to be quantified using sound economic principles. The functional differences and adjustments needed for comparison should be carefully done before selection of comparables are finalized.

Case Study 19 – Receipt of Services

Background: The assessee was engaged in manufacturing and sale of fast moving consumer goods. The overseas parent company provided certain management services (e.g., marketing support, logistics & IT support, public relations etc.) to all group companies. The parent company would charge fee (cost plus 5% mark-up) for the above mentioned services from all group companies.

The assessee justified the arm's length nature of the management services by benchmarking its operating margins using Indian comparables under TNMM, i.e. aggregating with it other transactions with AEs.

TPO's Contentions – Management Services Fee: TPO commented that assessee should provide the basis and actual workings for the costs pertaining to management services provided to it by the parent company. Further he commented that assessee should substantiate the arm's length appropriateness for the 5% mark-up earned by the associated enterprise. Further, the assessee should prove that services were actually received. Assessee should also be in a position to demonstrate the benefit derived by it from the management services

Assessee's contentions – Management Services Fee: Assessee submitted that a broad methodology was used for allocation/identifying costs pertaining to provision of management services provided to the TPO. The assessee further submitted that actual workings of costs and the economic analysis for substantiating 5% mark-up not submitted on the ground that the same were not available with the assessee. Although no records/evidence submitted to prove the receipt of services, an oral explanation was provided. Also assessee explained generally about the benefits derived from such services.

TPO's Stand – Management Services Fee: The TPO ruled that the onus to substantiate the arm's length nature of the international transactions is on the assessee. He further commented that the assessee's plea that the overseas information is not available cannot be accepted. In the absence of actual workings of the costs, the management services fee cannot be accepted to be at arm's length. He observed that no economic analysis given to substantiate the arm's length nature of 5% mark-up. Also, he commented that there was no

evidence placed on record to substantiate/prove the receipt of services. The TPO mentioned that assessee was not able to demonstrate clearly the benefits received by it from receiving management services.

TPO's Conclusion: Arm's Length value of Management Services Fee determined as NIL.

Research Finding –Management Services Fee: The researcher observed that it needs to be substantiated that the decision to avail the services from the parent company was independent and the services could not be availed at a lower cost in the host country. The benefits derived from these services needs to be substantiated with proper documentation. In absence of all this information, the service charges can be construed as payment for 'shareholders services'. The researcher submits that there should be a formal agreement for receiving management services, covering full details, similar to an agreement between two independent entities. It is further observed that proper back-up of cost/financial details pertaining to overseas entity is of prime importance. It is noted that Cost plus model may not be accepted by TPO. Hence, comparable service cost from a comparable company needs to be benchmarked for the prices paid for these services. It is also important that assessee should understand the allocation methodology of the overseas entity and document the same for benchmarking.

The researcher further submits that it is important to defend the mark-up charged and should use overseas comparables, if required. This is irrespective of the fact that fee of uncontrolled service provider should be compared. It is also required that proper documentation, substantiating the need of these services, for the assessee and operational benefits derived from each of the

management services received should be maintained. It will be prudent that the assessee maintains additional evidence (correspondence, mails, reports, etc.) for proving that the services were actually received by the assessee. The researcher would like to opine that it would be prudent to obtain such information during documentation stage on account of time constraints during audit proceedings. Also a separate detailed analysis of management services should be performed.

Interview Results

The survey questions were:

1. What are the major challenges in Transfer Pricing?
2. Will it be good to have a consistency in approach by both administrators and Taxpayers?
3. Do you think approach can be same for different types of business?
4. What is the best methodology to adopt?
5. What will you prefer – Entrepreneurship approach vs Transactional approach?
6. Do you feel any need of new regulation or the current statute suffice?
7. Why do you think dispute occurs in Transfer Pricing Assessments?
8. Although business decisions are prerogative of business managers, do you think commercial prudence and independence in decision can be challenged by authorities?

Table 30: Response to Questionnaire

Question	Taxpayer	Tax Administrator
1. Issues	Inconsistent Approach by Tax Administrator	Inconsistent and transparency in documentation
2. Will consistency work	70% - Yes 30% - No	No
3. Whether approach should be different	30% - Yes 70% - No	Yes. However loss making concept should continue for scrutiny
4. Best Methodology	TNMM (Entrepreneurship approach) in absence of proper documentation.	TNMM (transactional basis)
5. Your preference	Transactional approach in case documentation and details are available.	CUP for imports, TNMM (Transactional)
6. Need of new statute	No	No
7. Main reasons for dispute	Approach and objective	Approach and objective
8. Rights to question business decision	Taxpayer – No Consultant - Yes	Yes (Refer section 40(a), Transfer pricing rules)