

CHAPTER 5: IMPACT OF TRANSFER PRICING AND ALLIED ISSUES

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IMPACT ON INDIRECT TAXATION

Adopting an updated Transfer Pricing policy is a regular activity for the multinational enterprises which have a global presence. While adopting a Transfer Pricing policy, enterprise planners mainly focus on the issues in the context of Income Tax compliances. The policies adopted by a group generally encompass the rules and regulations of Income Tax statutes of various countries and hence follows the procedures sets out in Income Tax Act. However, when goods are transferred from one country to another or manufactured in one country and sold in another country, the compliance under Indirect Tax legislations like Customs and VAT also needs to be adhered to and hence while embracing a Transfer Pricing policy, the rules and regulations of various Indirect Tax Laws play a significant role .

Customs duty is applicable whenever goods cross the territory of another country and VAT is applicable on local/ domestic sale/purchase. While adopting transfer pricing policy, a Group usually covers all compliance requirements under Income Tax Act. However, while adopting such policy, it is observed that the group usually fails to embed the compliance requirements under Customs Act and VAT Act. Since the objective of Customs authority is conflicting in nature with that of Income Tax Authorities, considering compliance under all Indirect Tax for the group is important while adopting a transfer pricing policy¹⁶¹. . Therefore, a robust transfer pricing policy would be required for compliance under both direct and indirect tax to avoid increasing tax liabilities under one statute while complying with the rules and regulations of other taxing legislations.

It is observed that procedures and purpose of customs valuation rules are similar to that of Transfer Pricing rules, but since the objectives of both taxes are significantly different, a conflict may arise. Therefore, when any transfer pricing policy is adopted by a group to satisfy either of the taxation authorities, it cannot be concluded that it would satisfy the other authorities or help to comply with the rules and regulation of other taxing statutes. For example, in case the transfer price for sale of goods from U.S. to India is set very low to satisfy the Transfer Pricing authorities in India, a dispute may arise with the customs authority since the lower valuation will reduce the customs duty¹⁶².

¹⁶¹ For example, customs authority will be satisfied in case the value of the imported goods are higher than market price since the revenue of the customs department will be higher, while the Income Tax department will challenge such transfer pricing since high cost will erode the profitability and thereby will reduce the revenue of Income Tax department. Also if the import cost is higher and sales price cannot absorb all the cost, the excise department may not accept the sales price as transaction value.

¹⁶² Customs (Determination of value of imported) Rules, 2007 Sub-rule 3(a) of Rule 3 - states that in the case of imports by related persons, transaction value shall be accepted provided that examination of the circumstances of the sale of the imported goods indicates that the relationship did not influence the price. In Commissioner of Customs v.

The very basic valuation difference in both taxes is that, in Income Tax, generally enterprise level profitability is determined in order to understand the correctness of the arm's length pricing principle, whereas for the purpose of valuation of customs, the transactional level (Invoice level) data is analysed for levying customs duty.

In addition to the basic valuation difference as stated above, although the two revenue authorities have similar objectives, i.e. to maximize the revenue for the country, the process to ensure that is completely opposite. For example, in case of Customs, the basic purpose although remains same, i.e. to increase the revenue for the country, it will always ensure that customs duty, which is levied on the transactional value of goods moved into the country should not be evaded. Whereas, for the same goods, the objective of the Income Tax Act will be to ensure that by paying a higher price to the overseas supplier, the local taxpayer is not evading the Income Tax.¹⁶³ Therefore, a low transfer price will satisfy the objective of the Income Tax department, whereas, the same transfer price will defeat the objective of the customs legislation. Since the process for attaining the objective of Customs statute and Income Tax statute shares a common principle the Corporates should ensure that transfer price charged for a related party transaction should pass Arms-length pricing test.

The valuation principle for the purpose of levying customs duty is done based on *ad valorem*¹⁶⁴ duties and the rules and regulations for determining the value of the goods for customs duty are quite complex. However the basic

East African Traders {2000 (115) ELT 613 (SC), the Apex court held that it was permissible for the customs authorities and tribunal to pierce the veil of the importing company to determine the relationship and the nature of influence on the price.

¹⁶³ Customs duty is paid on value of goods imported. Hence any under valuation of goods will reduce the customs duty liability. Income Tax is paid on net taxable income. Hence if the value of the goods imported is higher the net income of the importer will be reduced and thereby the tax liability will be lower. A balanced valuation of the imported goods will be ideal for both the taxation purpose.

¹⁶⁴ *Ad valorem* is derived from Latin *ad valentiam*, meaning "to the value".

WTO ¹⁶⁵ guidelines suggest that customs duty should be levied on transactional value. Transactional value refers to the price paid for the goods imported in the country and the invoice value should be considered as transactional value. However, there are certain differences found for the valuation of goods imported for the purpose of trading and distribution in retail market. Also, customs valuation methodology focuses on ensuring that the valuation is not influenced by the relationship between the parties. Different countries have enacted various provisions and measures to verify whether the transactional value is influenced by the relationship amongst the parties, WTO¹⁶⁶ in its guidelines, has suggested some of the measures to ensure that the prices are not influenced. WTO has also suggested standard to ensure independence in the transaction which has been adopted worldwide for defining the relationship between the parties. Few examples of related parties under WTO guidelines are provided as below:-

- a) In case a person is director in one of the enterprises between which the goods are exchanged
- b) Partners of business
- c) Relationship of Employer and Employee
- d) In case a person holds directly or indirect more than 5% of the shares
- e) In case one of the person controls the other
- f) In case both the parties directly or indirectly owned or controlled by a third party
- g) In case both the parties directly or indirectly controls a third person
- h) In case both parties are members of the same family

Import duty is not imposed on the intangibles and therefore no duties are levied on the cross-border transactions involving intangibles. However, the

¹⁶⁵ World Trade Organisation (WTO) deals with the global rules of trade between nations.

¹⁶⁶ A handbook on WTO Customs Valuation Agreement, (2010), available at https://www.wto.org/english/res_e/booksp_e/handbook_cusval_e.pdf (Last accessed on Nov. 15, 2014)

intangibles and any prices paid for the intangibles form part of the valuation of the goods. Therefore, commissions, royalty, license fees, and any other payments made by buyers are added back to transactional value to derive import duty. Therefore, the Transfer Pricing policy for intangibles should be scrutinized very closely in order to avoid any additional liability in the form of customs duty. For example, to satisfy the Transfer Pricing guidelines, a royalty might be charged for the trademark, etc. However, the same will have an impact on customs duty valuation in case the royalty calculation process is not drafted clearly and any import from related party is not excluded from the royalty. Similarly, any true up or true down¹⁶⁷ for cost plus transfer pricing model has a direct impact on import duty of the purchasing country.

The researcher submits that although the customs duty on the imported goods are levied on transactional value in most of the cases, there might be some special rules prevailing in the country as mentioned above which should be taken into consideration while adopting a transfer pricing policy.

The transfer pricing policy for the goods to be transferred between countries should be formulated, taking into consideration the following points:-

- a) The policy should also adhere to the rules and regulation of the customs duty of the importing country
- b) The policy should be formulated to reduce the customs duty applicable on such movement of goods, wherever possible.

The researcher recommends that although Customs Act of respective countries follow the same principle of arm's length, justification for arm's length pricing for the purpose of transfer pricing may not be acceptable for

¹⁶⁷ True Up or True down adjustment in cost plus methodology occurs when the actual cost is different than expected cost based on which the price was set at the beginning of the year. At the end of the year, the actual cost is calculated and a Debit Note or Credit note, as the case may be is raised on the other party for recovery of the differential cost.

the purpose of Customs Act. The onus will be on the importer to prove that the prices disclosed for customs valuation is at arm's length and no influence exists on the pricing due to the close proximity between the parties. Researcher observed that valuation for customs purpose may include some notional cost¹⁶⁸ which is not considered for the transfer pricing purpose.

Assist are often overlooked part of the Transactional value. An assist occurs when something is provided to the international manufacturer "free of charge" or at reduced rate¹⁶⁹. The value declared to customs in respect of imported goods has to be "fully costed" value which will include the cost of materials, overheads, etc. Normally, a company would absorb all the cost. However, these items which are provided to the company free of charge, need to be included in value declared to customs.

Validation of the transfer price for customs purposes

Whenever goods are imported from related parties, the transactional value disclosed by the importer needs validation for the purpose of arm's length principle. To satisfy the requirement, the WTO guidelines suggest the quantitative and qualitative criteria for reviewing the price of the goods. However, unless the importer imports similar goods from an unrelated party, the quantitative and qualitative comparison cannot be done. The criteria for quantitative checking are:-

- a) The prices paid are similar to or closely similar to the prices charged between an unrelated seller and unrelated buyer at the same time;

¹⁶⁸ In absence of actual cost (like freight & Insurance), the notional cost is added to compute the duty liability. For example, rule 10(2)(c)(iii) prescribed that where insurance charges are not ascertainable 1.125% of FOB value should be added as notional charge

¹⁶⁹ For example, X Ltd (exporter) has provided marketing support (Free of cost) to the Y Ltd (importer) of the goods. In this case, the marketing support will be considered as "Assist" to Y Ltd.

- b) The prices are close to the custom's value for the identical or similar goods imported at the same time;

The qualitative techniques as suggested by WTO¹⁷⁰ in their guidelines have not been specifically explained. However the customs authority should ensure that -

- a) The parties to any transactions are not related or even if they are related, the relationship has not influenced the transaction ;
- b) The prices charged are similar to /closely similar to industry pricing practices;
- c) The prices are similar to the prices that would have been charged by an unrelated party;
- d) The prices charged by the seller should be able to recover all their costs;
- e) There are alternative methods for valuation like resale-minus method¹⁷¹, etc. In case any such alternative valuation satisfies the valuation rule for the purpose of customs valuation, no further action needs to be taken. In case any other adjustments need to be done for the customs valuation purpose, a prior application for advance ruling may be made;

Since the objective of both the Transfer Pricing and Customs authorities are almost same, i.e. to ensure that the prices charged for a transaction are not influenced by the relationship of the parties, the transfer pricing policy can be laid down in such a way that the same information should be able to satisfy both authorities.

¹⁷⁰ A handbook on WTO Customs Valuation Agreement, (2010) available at https://www.wto.org/english/res_e/booksp_e/handbook_cusval_e.pdf (Last accessed on Nov. 15, 2014)

¹⁷¹ Resale Minus or Deductive value is a valuation method in customs, whereby in absence of import value of the identical goods, the value is derived by reducing various selling costs from resale price of the good.

In case the transfer pricing adopted by a company is not acceptable by the customs authority due to the reason that the price paid for the transaction is lower than the acceptable value for the customs, the company can adopt the following alternatives:-

- a) The company can change the transfer pricing policy to cater the requirements of the customs authority as well;
- b) Approach the customs authority for special valuation and satisfy the customs authority that the valuation adopted by the company does not dilute the objective of the Customs Act;

The company while adopting one of the above approaches should consider the following:-

- i. The objective of customs authority is to ensure that the transfer prices are not low and the importer should pay the import duty on appropriate valuation. Whereas the revenue authority of the country where the goods are imported, has a conflicting interest to ensure that the transfer prices are not high and the local entity should be in a position to pay tax on their business. The interest and purpose of the customs' authority is more or less similar to the interest and objective of the transfer pricing authorities of the country from where the goods were exported. Both authorities, although from different countries and from different tax system, try to ensure that the transfer prices are not low. Therefore, any transfer pricing policy, which satisfies the need of the customs' authority of the importing country should satisfy the need of the transfer pricing authorities of the exporting country.

- ii. In most countries¹⁷², it is not a mandatory requirement to reconcile the inventory valuation with the customs value for the income tax purpose. However, in such countries where there is a requirement of doing such reconciliation, the components of such reconciliation item should be taken into account. In case a transfer price exceeds the acceptable customs value, the company should review the policy to understand whether such transfer price meets the requirement of revenue authorities of the importing country/ies.

Since Income Tax is levied on the profits of an entity and customs' duty is levied on the transactional value of goods imported, the following factors need to be considered while formulating the transfer pricing policy:-

- a) Customs value is levied on the full value of imports even if there is a loss whereas no income tax is charged when there is a loss to the entity;
- b) Even if a high transfer price is acceptable for the taxation authorities of the host country, it would result in additional duty liability for the entity and therefore will increase the overall cost for the group;

Customs department will accept the transactional value for duty calculation even if the transfer pricing authorities concludes that the transfer price is high due to related party influence. However, in some circumstances, a special valuation can be accepted considering the following factors:-

- a) Due to some agreement, if the final price payable for the goods imported will be quantified only after resale of those goods.

¹⁷² Like in India, reconciliation of the inventory value, declared for Income Tax Purpose, is not mandatory with the customs valuation.

- b) In case there are certain conditions imposed by the buyer on the seller, like where seller imposes restrictions on the buyer to resell to a certain section of the customers.
- c) The goods are not imported as purchase but under hire purchase or lease agreement

Transfers of intangibles

Customs duty is not levied on the intangibles . However, in case the cost of intangibles is charged separately, the value of the intangibles should be added for the valuation for import duty calculation¹⁷³ . Various types of intangibles, the valuation of which can form part of the valuation for import duty, can be listed as below:-

- i. Royalty or license fee for Trademarks, designs, patents and any other rights related to the imported goods;
- ii. Process support or any other assistance if the same is provided in the country other than the country of import;
- iii. Cost of computer software ;
- iv. Any payment for the right to resell the goods;
- v. Any fees separately paid in the form of license fee, royalty for the design, drawing, manufacturing process, etc.

However any payment made by the importer to obtain right to reproduce the goods in the country of the importation, are excluded for the purpose of the customs' duty calculation.

¹⁷³ Customs Valuation (Determination of value of imported Goods) Rules, 2007 Rule 10(1)(c): prescribed that royalties and license fees related to the imported goods that the buyer is required to pay, directly or indirectly, as a condition of the sale of the goods being valued, to the extent that such royalties and fees are not included in the price actually paid to payable.

Some of the other charges¹⁷⁴ which should be added to the cost of goods for calculation of import duty are as below:

Interest

In the event a purchaser extends loan to a manufacturer of goods and the supplier pays interest to the purchaser, the interest so paid by the supplier should be deemed to be part of the cost of production and therefore should be included in the price of the goods sold. However, interest paid by the supplier is not required to be included in the customs value of the imported goods.

Design, development, engineering and similar charges

In practice, the cost of design, engineering and other charges related to manufacturing of goods are included in prices paid for the goods purchased. However, in some cases, the exporter may want to charge separately for all these costs from its affiliates. In such cases, the cost needs to be added for valuation of goods for customs duty calculation.

The impact of transfer pricing policy changes

In case there is any change in the transfer pricing policy adopted by the group, the impact of such changes on the customs' valuation needs to be ascertained.

In case the change in transfer pricing policy has a significant impact, the policy must be reviewed to verify the acceptability under Custom's Act. The examples of significant changes can be:-

- 1) Allocation of profit from one entity to another
- 2) Shifting of responsibility from one entity to another

¹⁷⁴ Customs Valuation (Determination of value of imported goods) Rule, 2007 Rule 3: prescribed certain method to compute the value if the transactional value is not acceptable or ascertainable. In such case various costs are required to be added.

- 3) Any change in transaction structure, viz, change in resale organisation
- 4) Change in price or margin fluctuation

In case the subsequent price changes are significant, then based on the local customs law, the customs authorities may recover the arrear of the duty with penalty and interest, in case the changes result in the increase¹⁷⁵ in prices earlier paid. On the other hand, in case the prices are dropped subsequently, there will be no basis for claiming the duties overpaid.

The impact of retrospective transfer price adjustments

Since there are no specific guidelines in the WTO agreement with regard to subsequent adjustment of transaction value, the customs statute of a country determines the treatment of such subsequent price change.

Balance between customs valuation and Transfer Pricing analysis

Companies are recommended to focus on customs documentation with same sensitivity as it does for transfer pricing purpose. The documentation maintained for transfer pricing analysis may not be sufficient to support the customs valuation.

To avoid the fines and penalties under the customs law, transfer pricing policies should be reviewed in detail to align with the local customs statute, since any alternative pricing policy for customs' valuation may be difficult and costly to implement. The theory, that in case transfer pricing policy of a

¹⁷⁵ For example, the price of a good was considered as 100/- per unit at the beginning of the year. The importer purchased 10000qty throughout the year. Based on the contract, the exporter recalculated the actual cost and raised a debit note as retrospective adjustment in the month of December, for all earlier purchased made by the importer. In that case the customs authority may conclude the same as evasion of duty paid earlier based on the transactional value.

company is correct, the transaction value for customs valuation will be correct has been proved wrong in various situations¹⁷⁶.

However the transfer pricing report can be leveraged for deriving and supporting the basis for customs' valuation. This is after considering that all the required statutory adjustments are done and other factors are considered. The benefits for establishing a nexus between transfer pricing analysis and customs' valuation may be as below:-

- 1) It will help to decrease the accounting gap, and other issues related to pricing;
- 2) A uniform policy catering to the needs of both revenue and customs will help to reduce the additional liability as well as interest and penalties.
- 3) A complete solution for all product line and products
- 4) A foundation for requesting advanced pricing agreements
- 5) To identify valuation opportunities related to intangibles and goods (e.g. royalties, license fees, etc.)
- 6) Helping enhanced financial reporting compliance under SOX and ICFR

Transfer Pricing and impact on Competition Law

In most parts of the world, free competition is supported to ensure free trade and prevention of unfair business practices adopted by groups to eliminate competitors.

Transfer pricing plays a crucial role to ensure free trade since most of the companies in current scenario have majority of their input cost from their

¹⁷⁶ Although royalty and license fees paid by the Company was not disputed by the Transfer Pricing Authorities, in case of Commissioner of Customs v. Ferodo India Pvt Ltd, the Apex court held that the customs department has right and also the obligation to look into the pricing arrangements to ensure that the pricing arrangements are appropriately determined and to unravel the possibility of influenced pricing.

subsidiaries. Transfer pricing derived under any of the methodologies may violate the fundamental principle of fair competition in the host country, if the transfer price results into:-

- a) Predatory pricing to drive out the competitors
- b) Anti-competitive cross subsidization¹⁷⁷
- c) Price discrimination

Predatory pricing and anti-competitive cross subsidization is an anti-competitive practice by a firm which aims at monopolizing the market. Transfer pricing is one of the tools to achieve the goals to monopolise the market and driving out the competitors.

It is very hard to establish predatory pricing undertaken by a foreign associate company and to penalize it under Indian Competition Act¹⁷⁸. However, if the predatory pricing is the result of Transfer Pricing mechanism, Competition Commission of India may evaluate the option of invoking the provisions of Competition Act, 2002. Therefore, Transfer pricing mechanism can play a vital role to ensure fair competition by charging an arm's length pricing for sales/purchase of goods.

Therefore, before setting up a Transfer Pricing policy, companies should also look into this aspect to avoid violation of any competition law across the globe.

¹⁷⁷ Cross Subsidization is one of the anti-competitive conducts, when a firm sells its products at higher prices in a low competitive market so that it can sell its products at a lower price in a highly competitive market.

¹⁷⁸ The Competition commission in India in Johnson & Johnson Ltd case said that "essence of predatory pricing is below one's cost with a view to eliminating a rival". From reading of this statement, it is evident that to prove a predatory pricing situation, the cost analysis is needed. However, the cost of overseas enterprise will be subject to some assumptions and therefore proving a predatory pricing for a overseas enterprise will be difficult.

Tax Treaties and transactions between associated Enterprises

In order to avoid double taxation, various countries execute double taxation avoidance agreements with other nations¹⁷⁹. Generally these agreements are called Double Taxation Avoidance agreements (DTAA) or tax treaties. Double taxation avoidance agreements are important to refer to before entering into any cross-border transactions.

Some of the relevant clauses of Double Taxation avoidance agreement between India and USA¹⁸⁰ are discussed herein below:-

In accordance with Article 9 of DTAA entered into between India and USA, an 'Associate Enterprise' includes:

- a. Any enterprise situated in any of these countries but controls the management of other country;
- b. The same person controls the management and capital of the enterprises situated in either of the countries

In either of the conditions mentioned above, in case the business conditions are set in such a way that it cannot be considered as a business condition in an uncontrolled environment, then a profit which might have accrued to the enterprise under uncontrolled environment would be added to the profit of the enterprise in concern and tax will be applicable on such adjusted income¹⁸¹.

Article 9 of the Double Taxation avoidance agreement states that in case one of the entity situated in one of contracting states pays tax on the transaction

¹⁷⁹ India has signed various double taxation avoidance agreement. For reference, Double Taxation avoidance agreement with United State of America *available at* <http://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx> (Last accessed on December 10, 2014)

¹⁸⁰ *Available at* <http://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx> (Last accessed on December 10, 2014)

¹⁸¹ Article 9 of Comprehensive Double Taxation Avoidance Agreement between India and USA *available at* <http://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx> (Last accessed on December 10, 2014)

entered into with another entity situated in another contracting state and the prices paid for such transaction is based on arm's length principle, then the other contracting state shall appropriately adjust the taxes paid on the same transaction. However, such an act can be done only after consultation between the competent authorities of both the countries. This process is called Mutual Agreement Process (MAP).

It is important to note here that in case of MNCs, the business conditions mentioned in above two paragraphs and therefore any transactions entered into by the Companies should be scrutinized to review the applicability under Double Taxation avoidance agreement. For example, if a holding enterprise dictates the local enterprise to stop a product line or purchase goods and services at an incomparable price from its associate enterprise, then the local unit may be termed as dependent agent.

Royalties and fees for services and their impact are provided in Article 12 of the same DTAA. According to the clauses of Article 12 of the said DTAA, the royalties and specific services which are included in the said article will be taxed in the state where the enterprises are situated to whom the amount is paid. However, the same royalty income or income from specified services may be also taxed in the state where it arises. However the tax so charged in the state where it was arisen should not exceed a specified percentage as mentioned in the said DTAA.

However the most important part of the said DTAA is that the royalty paid or the amount paid for the specified services should not exceed the amount that would have been charged in a normal circumstances or an uncontrolled situation. Therefore, tax can exceed the percentage as specified in case the amount paid in excess of the amount that would have been paid in normal circumstances.

It is important to remember the conditions for taxing in the contracting states. The R&D activities undertaken by the group and charging royalty on the same should be scrutinized for impact identification before it is undertaken.

Relief from Double Taxation

As per the provisions of the said DTAA¹⁸², USA will allow a tax credit as below:-

- a. the income-tax paid to India by the resident;
- b. Dividend received by a United States Company owning at least 10% of the voting rights in any of the enterprise in India which distributes dividend and paid tax in India on such dividend Income

Conclusion

It is observed from the above analysis that Transfer Pricing policy has an impact on compliance of Indirect Tax regulations of the importer in the host country. Therefore, it is recommended that a comprehensive policy should be adopted by the Corporates to embed all the compliance requirements and not only the Income tax related compliances. Also from the discussion above it is clear that arm's length pricing is the only key to comply with various regulations. To select an appropriate arm's length pricing, the business modalities needs to be analysed.

However, there are needs for some better processes as well, which the government of respective countries should ensure. The interaction between customs department and Income Tax department should be increased to improve the processes and eliminate the uncertainties amongst the business communities about the competing authorities. The policies of and procedures of customs and income tax should be consistent and transparent to facilitate the importers to reconcile the differences between customs and income tax

¹⁸² *ibid*

rules. The customs and income tax department should work together and should have access to the documents available with them for establishing and enforcement of the statutes.