THE ECONOMICS OF TRANSFER PRICING AND PROFIT SHIFTING IN MULTINATIONAL COMPANIES: A CASE STUDY OF INDIA

1.Introduction

The enhancement of scope of trade all around the world, has given rise to issues from commercial, business and tax perspective. This has resulted into increase in transfer of goods tangible as well intangible throughout the world. The economies are no longer restricted to their own region but are moving towards global economies .The latest 'buzz' word has been One World – One Economy concept.

Multinational corporations have formed subsidiaries in various jurisdictions, inter-company transfer of goods and services within subsidiaries have attracted the attention of tax authorities since they involve related party transactions between associated enterprises.

It has been understood rightly as a technique for optimal allocation of costs and revenues among divisions, subsidiaries and joint ventures within a group of related entities(Prem Sikka, Hugh Willmott p: 342-356)[1].

Historically, tax policies have been developed around the world primarily to address economic and social concerns. The form and level of taxation were established having to regard the allocative, stabilizing and redistributive aims thought appropriate for the policies of the country.

The decision to have a high rate of tax and a high level of government spending or low taxes and limited public outlays, the mix of direct and indirect taxes , and the use of tax incentives were all matters which were decided primarily on the basis of domestic concerns and had principally domestic effects.

A survey of the Global 1000 MNEs by Ernst &Young found that "*MNEs throughout the world regard transfer pricing as the most important international tax issue their organizations will face over the next two years*" (Ernst &Young,2003 p.762)[2].

To briefly outline the structure of this dissertation, the transfer pricing problem in the international scenario is first discussed, followed by an in-depth study of the scope of

[1] Prem Sikka and HughWillmott (2010) "The dark side of transfer pricing*: Its role in tax avoidance and wealth retentiveness* A Critical Perspective" on Accounting 21(2010) 342-356.

[2] Ernest and Young (2003), Transfer Pricing 2003 Global Survey Practice, Perception and Trend in 22 Countries Plus Tax Authority Approaches in 44 Countries.

international transactions in Indian context. Further, the paper with the support of case study explains the notion of ALP and its various methods of computation. The paper then proceeds to survey the statutory framework of Indian laws required. Finally the paper suggests improvements in the legal framework and concludes.

Definition- Transfer Pricing

In simple terms, a transfer price is understood to be a charge at which inter-company goods or services are transferred from one division to another of the same divisions. The OECD Guideline on Transfer Pricing defines *"transfer prices as the prices at which an enterprise transfers physical goods and intangibles or provides services to associated enterprises."* [3]

The concept can be understood as a transaction taking place between two enterprises, whether related or unrelated at a determined price. The price agreed has to take various factors like availability of alternatives, pricing method, need of the parties etc. In order to appreciate the factors that influence transfer pricing policies in an MNE let us consider an example where there are two entities, one a manufacturer (A) and the other a distributor of widgets (B).If it is possible to shift profit from A to B, by shifting profits to tax havens in the transaction it is possible to increase post-tax profits. Non-fiscal factors play an important role in shaping transfer pricing decisions for MNEs, the efforts of all transfer administration is aimed at determining the correct value of taxable income (which represents income independent of any deviation due to factors caused by a special relationship between the transacting enterprise).The difficulty faced by the MNEs and the authorities in the intra-group transactions is to come to a consensus as to the "correct" taxable income. This issue has been discussed in Model Convention by the OECD which forms the basis Double Taxation Avoidance Agreement ("DTAAs")[4].

Transfer pricing evasion – illustration

Consider an example of a parent manufacturing in a low tax country with a 10% corporate tax rate and selling in a high tax country with a 50% corporate tax rate and incurring the following costs and revenue:

[3] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration(1995), published by OECD
[4]The Model Convention on Income and Capital (2006),published by OECD Model

Computation of Tax	£'000
Sales [in high tax country]	10,000
Cost of sales [in low tax jurisdiction]	6,000
Gross profit before expenses	4,000
Operating expenses [in low tax country]	1,000
Operating expenses [in high tax country]	2,000
Net Profit [in high tax country]	1,000
Tax [in high tax country] (@50%)	500

The above figure would demonstrate relationship between transfer prices and tax payments. If the transfer price is at cost (£6m + £1m) then the tax payable is £0.5m. However, tax would be minimized (ignoring the potential for tax losses) by setting the transfer price at £ 8 m which means that the profit of £1m [Transfer price £8m - Cost of sales £ 6 m - Operating expenses £1m] is shifted to the low tax country where it would suffer tax at 10% i.e. £ 100,000. The group after tax profit of the MNE increases .

Concept - Transfer Pricing Manipulation

This research seeks to outline the functioning of the law and its effort in preventing the menace of transfer pricing manipulation. Ultimately, the paper proceeds to question the need for change in the law and if so, the areas that requires change. In literal sense the term transfer pricing manipulation would imply fixing transfer prices on non-market basis (as against arm's length standard) to reduce the total quantum of organization's tax liability by shifting accounting profits from high tax to low jurisdictions. It changes the relevant tax burdens of multinational firms in different countries of their operations and reduces the worldwide tax liability.

MNC are highly motivated to invest in foreign countries by many factors that differ from one industry to another. An MNC may find it cheaper to manufacture its products where material

and labor cost are lowest- such as in Korea, India, Egypt and then export in Germany Japan ,European countries and USA here the selling price are the highest, thus achieving highest profits. The problem faced by the policymakers is the cross-country differences in tax rates, in particular corporate taxes. The transaction between enterprises has been elaborated in the Model Convention wherein profits are determined between independent enterprises under similar circumstances is known as the "arms-length principle". The consequences of such transfers may often be enlarged and cause deprivation of revenue and also lead to distortions in the Balance of Payments situation of a country.

Whatever maybe the reason for manipulation of transfer prices, it ultimately adversely affects the tax base of either of the countries involved. The remedy is to have aggressive policies to counter this but on the other hand it would drive away the foreign investments to a more tax favorable region.

2. International Transfer Pricing Practices in India

An Overview – Requisites for Transfer Pricing Regulations in India

One of the most daunting tasks faced by the multinational companies whether, Indian or foreign, is determining the prices at which goods, services and technology are traded between associated enterprises in different countries. Hence, the issue of transfer pricing has been in the forefront of strategic decision making for most of these MNEs. As understood, transfer pricing is a general term used for the price charged by an MNE in a cross-border related-party transaction.

Historically, transfer pricing has been a compliance-focused tax issue, with most companies focusing only on mitigating tax exposure. 'The Indian government, having seen the impact the transfer pricing policies of multinational enterprises(MNEs) can have on the tax revenues, has introduced detailed transfer pricing legislations. These legislations are a very important step taken by the country to curb tax avoidance and preserve its own tax base.

Concept of 'Transfer Pricing' in Indian Laws

The provisions relating to Transfer Pricing were introduced by an amendment mentioned in sections 92, 92A-F of Chapter X of Income Tax Act 1961 (in short I.T. Act) and the relevant Rules included in sections 271 (1)(c), 271 AA, 271 BA and 271G for Transfer Pricing are

Rule 10A-E of Income Tax Rules 1962 (in short I.T. Rule). The Central Board for Direct Taxes (hereinafter: CBDT) issued a circular on legislation to Curb Tax Avoidance by abuse of Transfer Pricing (Annexure II) to ensure that the profits chargeable to tax in India are not evaded by altering the prices charged and paid in intra-group transactions.

Direct tax: Laws relating to the concept of 'transfer pricing' in Indian scenario are laid down provisions under the Income Tax Act, 1962 which specifically provides laws for determination of 'arm's length principle', 'associated enterprise' and 'international transaction'. It also lays down penalties in case to tax avoidance by using transfer pricing as an instrument.

Section	Issues	Provisions
Section 93 Income Tax Act 1962	Avoidance of income tax by transactions resulting in transfer of income to non-residents	In case of transfer of asset, if the transfer(alone /in conjunction with associated operations) results in - income from transferred assets becoming payable to non-resident ; and -Resident acquiring rights to enjoy income of non-resident transferee or any capital sum becoming due to resident before or after transfer, the income of the non-resident is to be assessed in the hands of the resident.
Section 40A (2)(b)	Disallowance of expenditure not confirming to fair price	In case of payment to a relative /person having substantial interest in the taxpayers business, if the assessing officer is of the opinion that such

		expenditure is excessive /unreasonable in the view of the fair market value of the goods/facilities services and taxpayer legitimate business needs, he is empowered to disallow deduction to the extent deemed to be excessive.
Rules 10A,10B, 80HH, 80I, 80IA, 80IB Income Tax Rules 1962 (in short I.T. Rule)	Disallowance of relevant of relevant deductions	If the Assessing Officer believes that: - profits resulting from transaction is greater than ordinary profits, and Profits are artificially shifted due to a close connection with a unit eligible for deduction He is empowered to reduce the deduction based on the ordinary profits

Indirect tax

The concept of transfer pricing is also very much in vogue in indirect taxes in India. The provisions in the customs, excise law and service tax in respect of transactions with related parties (associated enterprise).Let us study various laws which influence the transfer pricing regulations.

Excise Law: It is an indirect tax which is levied under Central Excise Act, 1944 and rates are to be stipulated in the Central Excise Tariff Act, 1985. Excise duty is payable in the assessable value for which detailed valuation rules are provided .However , if goods are sold to related party , the invoice price would be the price at which the goods are subsequently sold to unrelated party.

Custom Duty: Under Customs Act, the transfer pricing are dealt within valuation rules. General Agreement on Tariff and Trade (GATT) valuation principle are followed for determining the assessable value, the price at which the goods are ordinarily sold between unrelated parties is accepted. The Special Value Branch of the Customs Department determines the assessable values of the imported goods in respect of transaction between related parties.

Service Tax: The Finance Act 1994 (Service Tax Act) does not contain any specific provisions relating to valuation of taxable services in case of transaction between related parties entities. The term *'associated enterprise'* has been defined as explained under Transfer Pricing Regulation under the Act; the service tax is to be deposited only upon the receipt of payment. But in case of transactions between associated enterprises, service tax is required to be paid immediately on accounting the transaction except in case of advance wherein the payment would to be made.

Corporate and other laws: Under the Companies Act 1956, the effect of transfer pricing on the profitability of the company is dealt in Section 211 wherein financial statements of the concerned financial year should give a true and fair view of the state affairs. The law puts an obligation on companies to make certain disclosure of transactions in which directors or persons having substantial interest. A detailed definition of associated persons, related party and related person is also provided.
Mandatory disclosure of related party transactions is also provided in accounting standard 18 issued by Institute of Chartered Accountants of India (ICAI).

Monopolies and Restrictive Trade Practices Act, 1969(MRTP): The MRTP Act provides the method to determine the price as well as detailed definition of a related person. The comparative definitions of associated enterprises, associated persons, related parties under the Companies Act 1956 and the MRTP Act 1969 are given.

- **Statutory Framework – Detailed Explanation on Transfer Pricing under Indian Income Tax**

The Finance Act, 2001 laid down provisions under Chapter X of the Act, "Special provisions relating to avoidance of tax" relating to international transactions between associated enterprise to ensure that it conforms to the 'arms-length principle'. The Transfer Pricing Regulation (TPR) as implemented in India has concepts similar to the OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines").

Tax treatment under exempted Income

A question may arise as to whether one needs to comply with the transfer pricing regulation if income is not taxable due to the tax treaty which India has signed with other countries.

Let us consider an example, India has signed a Mauritius-India agreement .If there is a capital gain to Mauritius based company from the sale of shares of an Indian company under the provisions of the Act may not be taxable on the basis of the tax treaty between India and Mauritius. The claim of non-taxability would be decided by the tax authorities.

Another case that requires attention is the *Rolls Royce Plc* (RRP) .The RRP supplied aeronautical engines and spare parts to certain establishments in India. It had wholly owned subsidiary in India by name of Rolls Royce India Ltd (RRIL).The court in this case found that the premises although in the name of RRIL , was being occupied by RRP for purposes of its business operations in India. Thus RRP had a PE in India within the meaning of Article 5(1) of the India- U.K. tax treaty. The Income Tax authority allocated 50% of profits to manufacturing activity that could not be taxed in India and 15% of the profits to research and development activity conducted outside India. The balance 35% of the profits was attributable to the marketing activity that was carried out in India.[5]

A land mark judgment in the area of International taxation *Director of Income tax (International Taxation) v Morgan Stanley and Co Ltd [2007]*[6] which decided fundamental issues such as fixed and service permanent establishment and transfer pricing issues. The issue in the case was that AAR in the case of Morgan Stanley & Co Inc, USA ("MSCO") held that MSCO had a PE in India considering deputation of employees by MSCO to India and stewardship services rendered by it to Morgan Stanley Advantage Services Private Limited ("MSAS"). It held that as long as the payment by MSCO to MSAS is at arm's

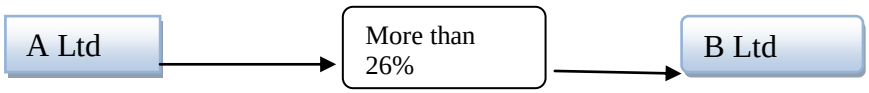
[5] Rolls Royce Plc [2009] 122 TTJ 359 (Del)

[6] Director of Income tax (International Taxation) v Morgan Stanley and Co Ltd [2007] 292 ITR 416(Supreme Court)

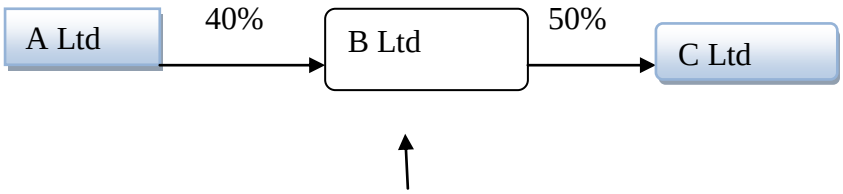
length, no further income can be attributed to the PE of MSCO. A special leave petition was filed against the ruling before Supreme Court of India to consider the matter.

Let us consider an example by support of a diagram,

1st Instance



2nd Instance



As can be seen from the diagram, in the first instance, A is holding directly more than 26% in B Ltd and, accordingly A Ltd and B Ltd are associated enterprises.

However, in the second instance since A Ltd is holding 40% in B Ltd (intermediary) which in turns holds 50% in C Ltd. As such, arithmetically though A Ltd is holding in effect only 20% in C Ltd. But indirectly through the intermediary it owns more than 26 % in C Ltd. In such a situation A Ltd and C Ltd are termed as associated enterprises.

International Transaction(s 92B)

In the context transfer pricing, the Income Tax Act defines International Transaction which would imply transaction between two enterprises. The necessary condition is that at least one of the parties to the transaction must be a non-resident. Transfer pricing regulation has defined the term to cover every likely transaction that may take place between associated enterprises.

Basic Components of Transfer Pricing Regulation in India:

The following diagram explains the basic components of the Transfer Pricing Regulation.

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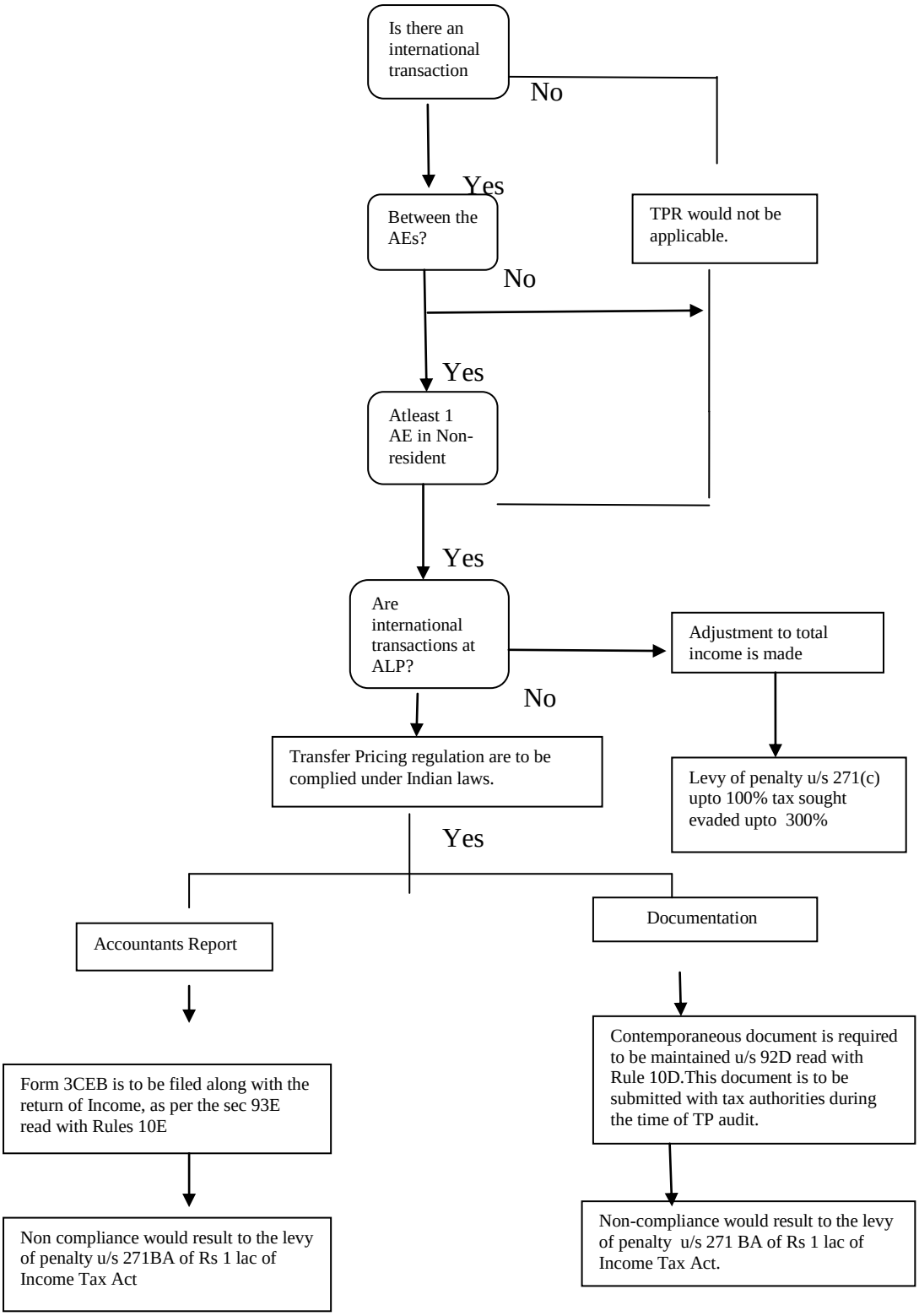

3. Judgments – Abuse of Transfer Pricing in India

The transfer pricing regulations were introduced in India in 2001 and there have been only 3 rounds of audit completed by the tax authorities. There are few cases that have passed through the chain of appeal proceedings. However few cases are being cited that are decided by Income Tax Appellate Tribunal (ITAT) which have been elaborate in line with the cases decided in matured jurisdiction.

Another landmark case is of *Fosters Australian Limited*[7], cross border sale of brand trademark and intellectual property rights by the Indian subsidiary of an Australian company (Foster's Group Australia) to a U.K. based company would be taxable in India. In this case as an agreement had been entered between the Australian Company into a brand license with India in return of a royalty amount received from Foster India. The AAR ruling has laid down that income attributable to such IP could not be taxed in India. It was held that the Independent Valuation Report be relied upon for quantification of true and correct value of taxable items.

In a number of decisions the tax authority has highlighted that benchmarking method as proposed by Company in preference over transactional profit method without any cogent reason[8], a preference of traditional benchmarking method (CUP, CPM and RPM) over profit based method (TNMM, PSM) and decided that determination of arm's length price is essential. It also held that the data of current year and operating items of the income statement are to be considered for analyzing the comparability under transfer pricing regulation.

As discussed earlier, *Director of Income tax (International Taxation) v Morgan Stanley and Co Ltd [2007]* in its judgment, the Supreme Court prevented the abuse of transfer pricing as it was noted that provision of back office and other outsourced services by Inc (Morgan Stanley Advantage Services Private Limited) "MSAS", a captive service provider would not constitute a Permanent Establishment of MSCO (Morgan Stanley and Co) in India, however

[7] Fosters Australian Limited [A.A.R. No 736 of 2006]
[8] Miss India Pvt Ltd [ITA No 393/PN/07], Honeywell Automation India Ltd [ITA No. 4/PN/08]

be regarded as a Service PE in India under Article 5(2)(1) of India- US Tax Treaty .With regards to attribution of profits to the PE of MSCO. Profits of foreign enterprise which have economic nexus with PE in India would be taxable. No further profits would be required to be attributed to the foreign enterprise where an associated enterprise that did constitute a PE is remunerated on the arm's length basis. It also observed that a robust transfer pricing analysis should adequately reflect the functions performed and risk assumed by enterprise.

Another case of *Ranbaxy Laboratories Limited* [9]was brought before the Commissioner of Income Tax wherein the taxpayer exported goods and services to its associated enterprise (AE).The prices were determined at arm's length price using the TNMM with the profit level indicator (PLI) of Operating Margin on sales. The dispute arose on the ground that the determination of ALP was not referred by the Assessing Officer to the Transfer Pricing Officer as was instructed under CBDT (Central Board of Direct Taxes). The tribunal upheld the decision and contended that no transfer pricing adjustment if the parties earn gross-margin within arm's length level as determined through the foreign benchmarking exercise after a flexible allowance of 5% from arithmetic allowance was provided.

Few other cases in the Indian scenario that highlighted the importance of appropriate comparability analysis to determine arm's length price are *Skoda Auto India Pvt Ltd(2009).*[10]*,Sony India (P) Ltd.(2008)*[11]*, UCB India Private Ltd*[12]*,*

One of the few most famous cases in the international scenario are ***Rochester (UK) Limited v Pickin***(1998 STC 138).The issue arising was that the Inland Revenue of UK authorities opined that business arrangement which Rochester UK (subsidiary) and Rochester(Canada) had entered with the Swiss Company was fraudulently inserted in the chain as a device for tax evasion of UK company profits.

As referred earlier *Compaq Computer Corp. v Commissioner*[13] where in the issue of locational advantage was discussed. It was admitted by the court that offshore affiliates do enjoy advantages of lower cost and wages. Another case that was brought for review is *DHL*

[9] Ranbaxy Laboratories Limited [2008] 114 TTJ 1(Del)110 : ITD 428
[10] Skoda Auto India Pvt. Ltd(2009) 30 SOT 319
[11] Sony India (P) Ltd.[2008] 114 ITD 448 (Del)
[12] UCB India Private Ltd [2009] 30 SOT 95 (Mum)
[13] Compaq Computer Corp. *v* Commissioner (Tax Code Memorandum 1999-220) (US Tax Court)

Corporation v Commissioner [14] where guidance on avoiding transfer-pricing penalties was discussed. In this case DHL entered into a memorandum of understanding (MOU) with DHLI wherein DHLI acted as a foreign pick-up and delivery agent for DHL in return DHL licensed the use of the DHL name for no compensation. No royalty was made payable for the use of DHL name. Later DHLI recognized the importance to have a need of a standard trademark therefore had the name registered in its name and had been licensed on a royalty – free basis. However later at the time of sale of trademark, DHL argued that DHL and DHLI were not related parties. The Court went into the merits of the case and imposed a fine of 20% as penalty on the failure by DHL to charge a royalty for the use of trademark while it was owned by it.

A landmark case of *Glaxo Smithkline Inc. (GSK) and Her Majesty the Queen* [15] is the Canadian distributor of the patented anti-ulcer drug "Zantac". The dispute centered on the transfer price for ranitidine, the active pharmaceutical ingredient ("API") in Zantac, for the years 1990 to 1993. Thus, it can be concluded that efforts made to evade taxation can be curbed by imposing stringent measures.

4.Summary and Conclusion

An Overview – The evolution of Transfer Pricing and its future

The overwhelming need for MNC s all over the world is to have a single international standard in order to reduce the incidence of double taxation. The application of arms-length principle has been debated since the first half of the century at the League of Nations Model Tax Convention. The reason for longevity of the principle is that although the principle has remained the same, the ways of applying the principle in practice has continually been evolved to take into account, the changing business or economic circumstances. Continuous debates have been taken place in 1979 OECD Report on Transfer Pricing as to whether arm's length principle be replaced by formulary apportionment, the issue gained limelight in 1995 OECD Model. The issue of '*comparability standards*' has been interpreted strictly. Secondly the method applied for determination of arm's length price has since then been a debatable issue.

Scope for future Research

[14] DHL Corporation v Commissioner [T.C. Memo, 1998-461, 76 TCM (CCH) 1122(1998),US Tax Court]
[15] Glaxo Smith Kline Inc.(GSK) and Her Majesty The Queen 2008 TCC 324(Canadian Court)

The tax authorities across the world are changing their positions on how best to manage transfer pricing and ways to curb tax avoidance. The policymakers are formally and informally holding parlance with taxpayers and professional for adopting best practices. The Indian tax authority is no exception to this rule. A need for effective co-ordination