

Transfer Pricing: A 'Taxing' Issue

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Abstract

The phenomenon of globalization has integrated all the markets on an international platform and India has been an integral part of it. The markets like capital markets, credit markets, money markets, etc. have been the predominant pioneers who have been taking it ahead. The insurance markets and commodity markets have been slowly creeping in and, it could be safely said that they have engulfed around it at a fairly successful rate. Electronics, software, motor vehicles, food & beverage, technology are few of the many examples available in the field work of globalization. Such global connectivity also gave a rise to many multi-national companies having their permanent establishments in many parts of the world. Such multiple existences gave ascension to an innumerable amount of taxation ordeals as, more than one government was asking for duties from the same entity.

The author, through this paper has highlighted the challenge that the transfer pricing regulations is posing towards the already established entities as well as the new and upcoming organizations. An attempt is being made to briefly explain what the concept of transfer pricing is and how it is affecting the countries the world over, and what measures should the organizations be taking to tackle such situations.

Keywords: Transfer pricing, markets, tax, development.

Introduction

The phenomenon of globalization has integrated all the markets on an international platform and India has been an integral part of it¹. The markets like capital markets, credit markets, money markets, etc have been the predominant pioneers who have been taking it ahead.² The insurance markets and commodity markets have been slowly creeping in and, it could be safely said that they have engulfed around it at a fairly successful rate.³ Electronics, software, motor vehicles, food & beverage, technology are few of the many examples available in the field work of globalization.⁴ The pace at which this has happened should be pondered upon. The catalyst for its acceleration has been the developed transport and communication, internet and better handling, packaging and shipment materials. Speedy mobilization of capital has been a key component of globalization. When it became clearer that funds could flow

¹ Mittal DP, *Indian Double Taxation Agreement & Tax Laws*, 117 (5th ed., 2008)

² *New ITR norms for high earners*, 15, Outlook Money 24, 24 (2016)

³ Ibid

⁴ Ahuja G, Gupta R, *Systematic Approach to Tax Laws*, 105 (5th ed., 2014)

freely from one part of the world to another, it created better investment opportunities throughout. Financial products like derivatives, bonds etc, helped the markets to capitalize and grab a seat on the globalization express. Trade opened at many parts of the world. Certain forms of government like communism⁵, which have been known to openly discourage international trade, fell which resulted into an opening of the doors for many investors in such countries.⁶ However, the biggest aspect for the rise in globalization have been the ever emergent multi-national companies which can be proven through the popularity of the brands like Apple, Microsoft, Star Bucks, etc.⁷

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The Concept

A multi-national company is an organization that is established world over and has its places of business having a control over the goods and services in more countries than one, excluding their own country of origin⁸. A multi-national company usually creates one or more of its own subsidiaries, in other countries, to develop its business base¹⁰. Thus, it enjoys a liberty of apportioning expenses to such subsidiaries. This liberty then can be used to cushion the management and accounting reports to be given to the share and stake holders. Such subsidiary companies either are integrated to be a part of the larger geographical norm or may function as its own, stand alone, entity as well.

The parent companies may be providing with a cushioning effect to the subsidiaries, but, if the perspective of the national governments is taken into consideration, they are keener on the statutory and obligatory annual returns of the subsidiary companies of the multi-national corporations. This stance is taken by the governments because a need is felt to check the prices that are being charged for the intercompany transactions that may be occurring between such multi-national company and its subsidiary companies. These transactions had come under the hammer, the world over, because of the global recession that had occurred¹¹. Another reason behind keeping a close eye on such transactions is that the stakeholders, especially the shareholders' wealth creation is solely dependent¹² on the performance of these companies. Moreover, the distribution of taxes between different countries of the world is also to be considered.

Thus, such multi-national companies need to understand the concept of transfer pricing which is explained to be in respect of the prices at which the companies deal in goods, services, tangible and intangible assets. The prices charged between controlled legal entities are considered. In the case being considered, when the subsidiary company sells goods to the multi-national company, the price charged by

⁵ Iyengar S, *Law of Income Tax*, 841(10th ed., 2005)

⁶ Vogel K, *Double Taxation Conventions*, 789(3rd ed.,1999)

⁷ *Steady Growth in a challenging climate*, 419, *The Economist* 29, 30 (2016)

⁸ *Supra* 6

⁹ Mittal D P, *Law of Transfer Pricing in India*, 435 (3rd ed., 2009)

¹⁰ *Ibid*

¹¹ *It takes two to tango*, 997, *Business India*, 78, 79 (2016)

¹² Lyons T, *EC Customs Law*, 203 (2nd ed., 2007)

such multi-national company to the subsidiary company is considered as a transfer price. Risks of non-compliance and faulty compliance are quite high in such transactions.

The Significance

Variations are a common norm when it comes to Arm's Length Pricing regulations as many countries tend to vary them¹³. The Arm's Length Pricing principle connotes that the multi-national companies are supposed to allocate the income and expenditure between the parties in such a way as if the parties are unrelated and the transaction that has been entered into, is done so to be in the best interest. The Arm's Length Pricing Principle is articulated in the Organization of Economic Co-operation and Development Transfer Pricing Guidelines along with the regulations as have been devised by a particular country. In India, a separate code of transfer pricing has been connoted in the Income Tax Act, 1961 which comes under Sections 92 to Sections 92F. These sections cover the intra-group cross-border transactions (applicable w.e.f. 1st April 2001) and specified domestic transactions (applicable w.e.f. 1st April 2012). These regulations are based on the Organization of Economic Co-operation and Development Guidelines¹⁴. There are different methods of calculation of transfer pricing that have been mentioned in this code. Along with the methodology, the documentation that would be required and the penal provisions post non-compliance have also been mentioned. The Indian Transfer Pricing Code clearly prescribes that whichever income that has been earned or which has arisen from the above mentioned international transactions or specified domestic transactions between such associated enterprises should be only be computed by taking into consideration the arm's length pricing principle which also includes any income or expenditure in the nature of an allowance. The Act has also provided with the definitions of 'international transactions' which include a transaction which involve two (or more) associated enterprises involving the sale, purchase or lease of tangible or intangible property, provision of services, cost sharing arrangements, lending/borrowing of money or any other transaction which may have an effect on the profits, incomes, losses, or assets of such enterprises.¹⁵¹⁶ The associated enterprises are the ones which include two non-residents or a resident and a non-resident, a foreign enterprise having a permanent establishment in India¹⁷. Hence, any transaction between a foreign enterprise and an Indian enterprise do come within the ambit of this code, which shows the point of view of the Government of India to keep in check and to increase the transfer pricing scrutiny of the transactions happening in India.

Perspective of Other Countries

Countries like U.S.A.¹⁸, U.K.¹⁹, and Canada²⁰ have also increased the scrutiny and have vigorously imposed their transfer pricing regulations. The developing countries

¹³ Deloitte, *Transfer Pricing Law and Practice in India*, 235, (2nd ed., 2009)

¹⁴ Ahuja G, Gupta R, *Systematic Approach to Tax Laws*, 659 (5th ed., 2014)

¹⁵ 38. *India*, Price Waterhouse Cooper, available at: <http://www.pwc.com/gx/en/international-transfer-pricing/assets/india.pdf>, last seen on 16/06/2016

¹⁶ Rohatgi R, *Basic International Taxation*, 212 (2nd ed., 2007)

¹⁷ Supra 13

¹⁸ *US Transfer Pricing Laws and Regulations*, US Transfer Pricing, available at: <http://www.ustransferpricing.com/laws.html>, last seen on 14/06/2016

¹⁹ *Transfer Pricing*, PWC, available at: <http://www.pwc.co.uk/services/tax/transfer-pricing-index.html>, last seen on 14/06/2016

like Russia²¹ and Mexico aren't far behind themselves and they have strengthened their hold as well. 'Maquiladora'²² tax structure in Mexico was known to be a bit liberal but the same was tightened by the Mexican government and with a vision of making an entry into such transactions, a bit difficult for the businesses. Russia's transfer pricing regulations are considered to be a stricter version of the OECD ones. The economic size of the mentioned countries is quite large but this should not create an adverse impression that transfer pricing regulations are only dealt with by the economically advanced countries. North African nations, Middle Eastern nations have also taken an active stand to curb the gaps in transfer pricing legislations²³. The countries like Turkey, Egypt and Israel have already come up with their fully implemented and functional transfer pricing regimes. The wide engulfment of the regulations emphasizes how businesses need to get themselves acquainted with these litmus tests²⁴.

D.N.A. Analysis

A multi-national corporation while going for a transfer pricing calculation has to opt for a fact specific profile. The calculations measures, if contain a very nominal degree of complexity, would end up helping the organization. If the corporation has its roots in many countries, then it does result into a transaction having multi-jurisdictional trigger points. It is irrelevant whether the transaction includes goods of various kinds, inter-company services, tangible as well as intangible assets, financial instruments, etc.

While entering into the transfer pricing compliances, a multi-national organization should conduct a D.N.A. analysis of its entire contingent (subsidiaries included) i.e. the functions that it carries out, the tangible and intangible assets that it owns and the risk, return and ownership norms attached to them. Certain common functions like manufacturing, servicing, sales & distribution, protection of intangible assets do come handy in such analysis²⁵²⁶. The multi-national corporation, in this case, if is in the nature of a parent company, it is to be assumed that it is responsible for the activities of all of its subsidiary companies. The world functionality trend has shown that the ownership norms of the intangible assets are usually with such parent companies. Post analysis, the financial data analysis should be conducted which would give out the core value of each transaction that is to be entered into²⁷²⁸. When both the activities get combined, the multi-national organization may get a clearer picture and can devise a suitable transfer pricing plan. The factors used for comparison²⁹ in such data

²⁰Transfer pricing rules in Canada, BDO, available at: <http://www.bdo.ca/en/library/services/tax/documents/transfer-pricing/transfer-pricing-newsflash-basics.pdf>, last seen on 14/06/2016

²¹63. Russian Federation, PWC, available at: <http://www.pwc.com/gx/en/international-transfer-pricing/assets/russia.pdf>, last seen on 14/06/2016

²²Big maq attack, Economist, available at: <http://www.economist.com/news/business/21588370-50-year-old-export-industry-provides-millions-jobs-has-reinvent-itself-quickly>, last seen on 14/06/2016

²³Ibid

²⁴Ahuja G, Gupta R, *Systematic Approach to Tax Laws*, 700 (5th ed., 2014)

²⁵Mittal D P, *Indian Double Taxation Agreement & Tax Laws*, 232 (5th ed., 2008)

²⁶Mittal D P, *Law of Transfer Pricing in India*, 506 (3rd ed., 2009)

²⁷Ahuja G, Gupta R, *Systematic Approach to Tax Laws*, 707 (5th ed., 2014)

²⁸Mittal D P, *Law of Transfer Pricing in India*, 450 (3rd ed., 2009)

²⁹Deloitte, *Transfer Pricing Law and Practice in India*, 140, (2nd ed., 2009)

management analysis usually include geographical locations, trends, fixed and variable costs to be incurred, etc.

Illustration

If company A is selling goods to company B, its subsidiary for Rs. 5000/- and the same goods are being sold to company C, a company which is not related to company A for Rs. 4000/-, then the transfer pricing principle would suggest that while calculation of prices, the one to be considered would be Rs. 4000/-. This is so because, if the amount of Rs. 5000/- is considered, it shows that the entity A is unduly inflating the prices, so that it can show more expenditure and resultantly, less amount of profit, as on that balance Rs. 1000/-, it is not paying any taxes to the government.

The considered example is quite straightforward and reveals the important aspect of transfer pricing that need to be considered, however, in reality, the process is quite complicated³⁰. The complications increase when an intangible property is being used as there are always chances of the ownership and usage to be different in the constituents of an intangible property. Without having an understanding of where the appropriate returns are being paid, it becomes next to impossible to properly grasp and understand from where the transfer pricing calculations have come forward from.

Conclusion

A multi-national corporation is supposed to be having certain unique USPs about itself that herald the opportunities and exposures linked to the transfer pricing regulations. When considering an inter company, or an inter entity transaction, it is a very basic expectation from the management to have a grasp over the knowledge of the issues, challenges, necessities and requirements of each jurisdiction.

The entire transfer pricing process is purely compliance oriented and these compliances require vigilance along with intelligence. If tackled with a lethargic and a careless attitude, it may lead to quite a disastrous effect, as the multi-national corporation may itself be faced to pay a huge amount of penalty and an increased amount of such transactions would certainly result into a loss of face from its stakeholders. The regulations of transfer pricing are indeed a taxing affair and only an in-depth understanding of the concept can actually bear fruits to it.

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