Chapter 5.

Conclusion
5.1 Conclusions relating to hypotheses

5.1.1. Relating to hypothesis 1:

From the finding of the data it is very evident that the approach of the Income Tax Department is to collect the rightful tax and that of the tax payer is that of tax liability reduction to the extent possible. The tax payer is looking to maximize his global PAT and in doing so tax is a cost for him. Hence he is justified in tax avoidance (Refer to chapter 2 for details this term) till the point possible. The Income tax department is a major revenue generation point for the Indian Government and hence collecting all the rightful tax is the duty of the tax authorities. Looking at the quantum of international trade happening between related parties it is obvious that the tax authorities are worried about the rightful tax collection. In fact in the OECD’s Forum on Tax Administration in its Seoul declaration identified transfer pricing as one of the significant concerns for tax jurisdictions (Deloitte, 2009). Thus there is no doubt that transfer pricing at ALP is an issue of major concern for the tax authorities.

The government requires revenue for governance, development, maintaining law and order, and many such functions of the government. Revenue from the corporates and the individuals is a major source of revenue for the government. For a developing country like India, where in the government has to do a lot of expenses for development, and that it is facing a lot of issues on the fiscal deficit side. Hence collection of all the rightful tax is a requirement of the hour. Thus the welfare aspect for the government demands that it gets the revenue from all planned sources. Hence the approach of the tax authorities for collecting all the rightful tax is highly justified.

The MNC’s are motivated by the capitalist principles. Hence maximization of the shareholder’s wealth is what they look at. For this purpose the main highlight for the MNC’s is to maximize their global PAT. In doing so tax management also is an important aspect for the MNC’s (Choe & Hyde, 2004) (Korn & Lengsfeld, 2004). Along with this the MNC’s have other objectives to fulfill, like generating and deploying funds for investment in the desired location, balancing global risks, achieving global targets and goals, etc. For all this purpose they require to move funds from one location to other at the least possible cost. For all this purpose transfer
pricing is a vital tool available with the MNC’s. It is cost effective and helps in global PAT maximization (Sikdar, 2006) (Urquidi, 2008).

The reasons for disputes sighted in the analysis of the cases done as mentioned in the findings (refer to chapter 4, findings from TPO orders 4.1), also highlight the contradicting approach of the tax authorities and that of the tax payer. The arguments put forth in the TPO orders bring us to a conclusion that the tax payer is trying to avoid as much tax as possible and the tax authorities are trying to recover as much tax as possible. This is a contradiction. None of the two sides are compromising on their stand and hence the number of cases into litigation in India is also very high. This can be said even from the fact that out of 887 companies and 1606 cases, in 682 companies and 1078 cases there is addition to ALP made. Meaning out of the sample, in 67.12% cases out of 76.89% companies there is contradicting approach of the tax payer and that of the tax authorities. This indicates contradiction in approach of the parties.

For instance, in cases of corporate guarantee given by tax payer to AE, the tax payer claims that there is no transaction since there is no cost is involved for the guarantor. Hence the question of ALP for the same does not arise. There is no price charge since there is no cost. Thus nothing is charged to the AE. Such a claim is countered by TPO saying that there is gain to the AE due to the corporate guarantee and hence the same must be treated as bank guarantee and charges for the same should have been charged. In such cases the approach of the TPO is to get rightful tax and that of the tax payer is to avoid all possible tax. Similarly there it is found that the tax payer has used various different reasons to justify the claim for ALP. This is found over the period of time as well that, the tax payer has been making attempts to find different heads to do transactions with AE, and claim adjustments for the same, indicating deliberate mess up to save tax liability. The TPO has countered the same by rejecting these claims by the tax payer. A huge number of such instances were found during the analysis of the cases. (For further elaboration refer Annexure 4 page 250, a published paper of the researcher where he finds principle reason of dispute being clash of philosophies governing tax payer i.e. Capitalism, and tax authorities i.e. welfare; section 4.3 Findings from reported cases, page 144 onwards; section 4.4 findings from interviews, page 152 onwards; also table 3, page 128)
From the above it is clear that the approach of the Income Tax department is to collect the rightful tax and that of the tax payer is that to maximize his global PAT and fulfill his objectives. For this TP is used as a tool. Hence approach towards international transfer pricing, that of the income tax department and that of the tax payer is contradicting each other, resulting in acceptance of hypothesis 1. That is: The approach of Income Tax department and that of the tax payer towards transfer pricing is contradicting each other.

5.1.2. Relating to hypothesis 2:

The reasons for dispute between the income tax department and the tax payer are classified into reasons of dispute arising due to taking legislation into incorrect spirit and disputes arising due to having difference of opinion about the subject matter of case or facts of case.

The legislation about the transfer pricing in India as well as the OECD guidelines are framed on the belief that there will be self-compliance by the tax payer about the legislation and the role of the tax authorities will be limited to only checks for satisfactory compliance. However for this to happen, the tax payer has to take the spirit in the legislation in the way it is meant to be. With TP being used for various purposes this is difficult proposition. The data shows that 12 out of 19 reasons pertain to disputes arising due to taking legislation in incorrect spirit (table 4, page 120). Top two reasons by highest frequency are ‘agreement on comparable’, and ‘Basis of adjustment to expenses/income’. The arguments from which the classification is made highlight that the tax payer is doing every bit to save addition to the income by way of adjustment to the ALP for transfer price. (Deloitte, 2009), say that the international trade is not entirely driven by market forces. However what drives them is not specified by them.

To quote a few examples to elaborate the spirit in interpretation of the legislature, attention is drawn to the chapter 2, where in the Indian legislature states that the multiple year data of the comparable may be used to compute ALP if such data is of significance to the situation. The OECD guidelines state that multiple year data may
be considered to arrive at ALP. This is conveniently interpreted by the tax payer by using multiple year data to compute ALP which is close to his transfer price. In other such cases where in internal uncontrolled comparable were available the tax payer; instead of using CUP method with internal comparable, has used TNMM or external comparable for CUP method to justify his claim for ALP. In case of brand fee paid to the AE, the TPO has disallowed it in all cases with a stand that the brand is not registered in India. It makes business logic, to pay brand fee if the brand is expected to have impact on the revenues of the tax payer. The TPO in these cases has stuck to the statements correct in the law; however he has not paid attention to the business logic.

Through the years on the time line, it is found that the adjustments to the ALP made by the TPO are changing. The TPO's were not that aggressive in making additions. Looking at the approach of the MNC’s they have become aggressive in making the adjustments to the ALP. The approach of the tax payer is found to be of avoiding all tax that is possible.

The spirit in the legislation is lost and the legislation is being interpreted in the correct text. This is exposing the possibility of twisting the legislature in the way desired by the tax payer or that by the tax authorities. The intention behind the transaction is not seen. The same is disguised by the tax payer into various aspects which come out as reasons for dispute between the two. In (M.CT.M. Chidambaram Chettiar & Ors. vs. Commissioner Of Income Tax, 1965), the Supreme Court of India has held that the intention behind the transfer has to considered before making any decision on tax avoidance by the tax payer. Thus in international transfer pricing at ALP, the intention behind the pricing is to be considered before making the TP audit. The spirit of the legislation is of self-compliance for non-tax avoidance. If the same is not taken correctly the intention behind the TP is doubted to be not of tax avoidance. (For further elaboration on the same kindly refer to section 4.1.1 findings relating to each reason, page 129 onwards; also refer section 4.4 findings from interviews, page 152 onwards; also to table 4, page 128)

On analysis of the orders and the reasons supporting the incorrect spirit it is concluded that the OECD guidelines and the Indian tax legislation is not taken in the intended
The hypothesis 2, that The OECD guidelines and the Indian legislation are not taken in the intended spirit is hence accepted.

5.1.3. Relating to hypothesis 3:

Once the spirit in the legislature is not taken in the intended manner, the disputes on the text of the legislature take over in the arguments. The design of the OECD guidelines and the Indian legislature is of self-compliance, adhering to the spirit of legislature of self-compliance. However due to the design of the legislature the text of the legislature is loosely knitted. This means that there are gaps in the text of legislature which can be conveniently interpreted the way desired by the tax payer, and all of it is correct in the text of the law. The tax authorities are also free to do the same. (Stuart, 2009) Has said that the subjectivity in the legislature causes disputes.

For instance the tax payer has given reasons for selection of a CUP method to compute ALP, for the same the TPO has given his own reasons for selection of TNNM. Both are correct in law. Similarly interest on loan given to AE, is also subjected to ALP. For this ALP there is no fixed benchmarking. The LIBOR or MIBOR or even the PLR of Indian banks can be taken. Tax payer selects the one suitable for him and the TPO takes the one which gives maximum tax. Similarly in cases of contradicting reasons cited by TPO and the tax payer, for adjustment to ALP; it can be seen that both; the tax payer and the TPO is correct in law due to the subjectivity in legislature. (Refer section 4.1.1 Findings related to each reasons, page 129 onwards).

Out of the 19 reasons found, 7 pertain to the disputes exclusively due to having difference of opinion on the subject matter and facts of the case (refer table 4 page 128; section 4.1.1 Findings related to each reasons, page 129 onwards). The other 12 reasons are found to be due to taking the legislation in incorrect spirit, but this in these cases has led to interpretation of the text of the legislature in the way the tax payer desires or the tax authorities want. Both of these interpretations are correct in the text of the legislation. This means that all the 19 reasons of dispute are due to subjectivity in the legislature. Hence the hypothesis 3 is accepted that, subjectivity in the legislation is causing controversies among Income tax department and the tax payer.


5.2 Other Conclusions

Lot of adjustments have to be made to the comparable price so as to arrive at ALP. This is subjective and adds to the problem of disputes. This is true especially in case of CUP and TNMM. Local data bases are big but at times getting comparable for a specific type of transaction and country is not possible from the data bases. Global data bases may be used in this case for the purpose of finding comparable.

Royalty payment is area of dispute in all the cases. The quantum of royalty paid should really depend on the type of product and its market potential. Royalty is paid generally for use of intangible asset like patents or copy rights. Since all the royalty transactions are unique, the comparison for the same is not possible. Cost based pricing is also not a correct method of doing it. There are methods and guidelines for valuation of intangible assets which can be used. These are not used. Use of these methods will give a logical way of valuing these transactions for ALP computation purpose which will reduce the disputes.

Payment of agency commission is also an issue of major dispute where in all cases involving commission payment has disputes. The point to be considered in case of commission is, what is the service provided, how tough is the competition, what is the risk taken by the agent, which market and country is the location of service, market entry barriers, any peculiar situation of the product and market, the economic situation of the market country. Any small change in any of the situation and the transaction becomes unique for comparison. Using CUP method or TNMM for this kind of transaction is hence not possible, so is any cost based method. The transactions have to be treated as if transaction for intangible asset owned by the agent and valuation being done in that manner so as to avoid disputes regarding the ALP for the same

For technical services and management fees expenses, there have been disputes on what is to be taken as comparable. There are such instances in case of organizations working in division form of setup. In this case as a matter of management control and pricing of head office compulsory nature of services, cost based methods are
suggested (Anthony & Govindarajan, 2010). It is accepted by the author that there will be disputes about pricing of the head office expenses, and the services of compulsory nature may be priced at cost, without adding any margin. Similar approach for these services for international transactions may be used. However for ALP some amount of markup has to be there which may be taken as gross margins of the tax payer to make matters simplistic. Net margins reflect the nonoperational expenses, which do not have impact on such services. Hence gross margins are recommended.

The department should declare in advance the criteria for selection of comparable so that the tax payer is aware of the basis of comparable selection by the tax authorities. This will help in better compliance by the tax payer and hence lesser disputes.

International transfer pricing has been researched with its tax impact for some time but research into the intentions behind the transfer are not yet studied in detail for the sheer importance of the data that it is not revealed. International TP has a very vide impact on economy and management of the enterprise.

International transactions have a direct impact on the foreign currency flow from one economy to other. A country like India where in there is a big concern about the current account deficit of the economy, the transfer pricing is also an issue when it comes to the balance of payment situation of the economy. This is highlighted from the fact that additions due to ALP adjustment by the income tax department has raised tax claims to the extent of 12.55% of India’s current account deficit in financial year 2009-10 as found in one of the papers by the researcher. (Paper attached as annexure not forming part of thesis).

This means that the profits made from the economy are flowing out of the economy, meaning that the economy at large is may not be benefiting in long run by such activities of the MNC’s.

The MNC’s divide the organization into divisions and the same is treated as a profit center for the purpose of performance evaluation. In case of regulated prices by the foreign AE, the input and or output pricing is out of control of the head. Hence the
concept of profit center is not implemented in its true sense. It is an adjusted profit center and the result is that the head of such a division is not evaluated on his profit performance but his other skills which are not as such the criteria for a profit center head.

TP is a preferred tool for fund transfer for a various reasons. Firstly it is the most cost efficient way of repatriation of funds. Secondly it’s a very effective tool to recover investment, so as to manage political and locational risks. It is a tool which takes care of restrictions on movement of funds, and repatriation of profits and funds.

5.3 Alternative way of taxing international related party transactions

OECD has given an alternative method for taxing international related party transactions, called formula apportionment (Refer to Chapter 2 for details of this term) method. However OECD, in its guidelines has said that this is very complicated, cumbersome to implement, and practically not feasible.

(Bradford, 2003) Has given indication towards finding solution in cash flow based taxation instead of origin based taxation for solving TP problems (refer to chapter 2 on literature review for details). Furthering based on cash flow based system of taxation, a completely new model that eliminates the disputes and is more objective is the required. Hence price irrelevance model is introduced through this work at a conceptual stage which will have to be further studied.

5.3.1 Price Irrelevance Model

Currently in most of the countries all the international payments for more than specified amount, one time or periodic, or based on quantity are subjected to tax deduced at source (TDS) which is also called as withholding tax. In India the rate of TDS is presently 10%. It means that the 10% of the payments made on this account are deducted and paid to the government as at source tax deduction. This is also called
is some countries as withholding tax. This TDS is at a flat rate. If the valuation of the asset is not fair, there can be following situations:

1. Over pricing by the AE to tax payer
2. Underpricing by AE to tax payer
3. Overpricing by tax payer to AE
4. Underpricing by tax payer to AE

Situation 1 and situation 4 will give similar tax impact, so will situation 2 and 3. So let us club the situations as asset is overpriced or asset is underpriced.

1. The asset is overpriced:

When the asset is overpriced the AE gets extra value for the asset on which no tax is paid. The tax payer claims the deduction for the payment as cost and reduces its profit. The tax payer reduces its tax payment by claiming higher deduction on account of cost of asset. There may be a case of tax management where in the taxes of the country of tax payer’s location is higher than the taxes at the location of AE. Overall there is loss to the tax payer’s revenue authority. This is coupled with the uncertainty that the assessment will through up the cost to the tax payer by way of attorney and time for representations to the tax authorities to satisfy them about the fairness of the price and of course if proved wrong the penal price. The tax authority has a cost for fair tax administration and collection, a mechanism for fair tax administration. This uncertainty also plays a big role in business decisions. There is a need to have a clear and non-subjective method for eliminating the uncertainty.

2. The asset is underpriced:

In case the asset is underpriced, the AE gets less amount of consideration. The tax payer gets less deduction for cost of acquisition of the asset and hence has higher profits. Tax collection is enhanced from the tax payer. There may be is a case of tax management in which the country in which tax payer is located has lower tax then the country where in AE is located. There is relatively
higher tax collection in country of tax payer and lower in the country of AE’s location.

All the uncertainty in the tax payable and the assessment of ALP by the tax authorities of tax payer’s location and the costs for the tax payer for representations, dispute settlement, attorney, etc. for the tax purpose and the possibility of revenue collection loss for the tax authorities and tax management from the point of view of the tax authorities can be eliminated. The concept is of the price of transaction not being material to the consequence of tax payment. This proposition is named by researcher as **Price Irrelevance Model**.

### 5.3.2 The Price Irrelevance Model goes as under:

The tax management comes into picture because of the fact that the tax rates at the locations of the AE and that of tax payer’s location are different. This difference is used to the advantage by the enterprises in management of tax. There is a clear arbitrage opportunity for reduction in the overall tax payable enhancing the profit after tax (PAT) of the overall group. The tax authorities stand to lose the rightful revenue from the transaction in form of tax. This situation can be eliminated.

The international transactions with tax payer are to be subjected to TDS at the corporate tax rates prevailing in the tax payer country. This will nullify the arbitrage opportunity created due to the difference in the tax rates of tax payer country and the AE country. The situation that will arise due to the TDS at corporate tax rates is as follows:

1. In case of over pricing by the AE to tax payer and in case of underpricing by tax payer to AE:

   The AE payment will be made at agreed price less the predefined TDS rates decided. The tax payer claims deduction on the amount paid to AE. His profits are reduced by that extent of the payment made to AE and the profits reduced. AE remittance is reduced by the TDS rates. This means that the tax authorities
are receiving the TDS on payments made to the AE at TDS rates. The revenue authorities get their due. The AE is charged extra as TDS / withholding tax.

2. In case of underpricing by AE to tax payer and in case of overpricing by tax payer to AE:

The payment will be made to AE at the agreed price less the TDS at decided tax rates. This price will not be fair price but a price lower than the fair price. The tax payer will be able to claim only the price of payment to tax payer as the deduction as business expenditure. His profits will be more by the amount of underpricing made for the transaction made with AE. This extra profit will be subjected to tax at corporate tax rates. AE is charged less TDS which is recovered through tax from tax payer.

This price irrelevance model needs to be further studied for detailing on avoiding double taxation to the tax payer, ease of implementation, constitutional requirements, etc.

5.3.3 Use of the Model

The PIM basically eliminates the computation of ALP for transfer price. Hence the disputes arising due to agreement on ALP are completely eliminated. PIM is expected to work on similar lines of that of the mechanism of sales tax, but restricted to related parties international transactions. Explanation as to how PIM will eliminate the disputes is given below based on the 19 reasons found above. (For details of the reason refer to annexure 2)

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Reason Code</th>
<th>Dispute Reason Description</th>
<th>Role of PIM in Eliminating the Dispute</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>Product &amp; business differentiation adjustments</td>
<td>No comparable is required in PIM</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Agreement on comparable</td>
<td>No comparable is required in PIM</td>
</tr>
<tr>
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<td>----------------------------------</td>
</tr>
<tr>
<td>2</td>
<td>2</td>
<td>Reasons for adjustments to ALP</td>
<td>ALP computation is not required in PIM</td>
</tr>
<tr>
<td>3</td>
<td>3</td>
<td>Basis of determination of ALP</td>
<td>ALP computation is not required in PIM</td>
</tr>
<tr>
<td>4</td>
<td>4</td>
<td>Application of Method for ALP</td>
<td>ALP computation is not required in PIM</td>
</tr>
<tr>
<td>5</td>
<td>5</td>
<td>Deliberate mess up by tax payer on allocation</td>
<td>Being Transaction based tax chances of mess up by tax payer are almost nil</td>
</tr>
<tr>
<td>6</td>
<td>6</td>
<td>Corporate guarantee, its cost &amp; Notional Interest</td>
<td>Corporate guarantee being deemed transaction PIM takes care of its taxation</td>
</tr>
<tr>
<td>7</td>
<td>8</td>
<td>Share application money as loan</td>
<td>Being a transaction it will be covered by PIM</td>
</tr>
<tr>
<td>8</td>
<td>9</td>
<td>Basis of adjustment to expenses/income</td>
<td>Being transaction based tax adjustments are not required</td>
</tr>
<tr>
<td>9</td>
<td>10</td>
<td>Documentation, evidence</td>
<td>Disputes are case specific and factual. They may continue to remain, however they are very less in number and can be taken care by detailed procedural rules</td>
</tr>
<tr>
<td>10</td>
<td>11</td>
<td>Deemed Loan</td>
<td>One of the reasons which may not be covered by PIM since it hidden in a transaction.</td>
</tr>
<tr>
<td>11</td>
<td>12</td>
<td>Royalty Payment/Brand Fee</td>
<td>Being a transaction it will be covered by PIM</td>
</tr>
<tr>
<td>13</td>
<td>14</td>
<td>Interest free loan</td>
<td>Being a transaction it will be covered by PIM</td>
</tr>
<tr>
<td>----</td>
<td>----</td>
<td>--------------------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>14</td>
<td>15</td>
<td>Comparable not available at time of filing taken by AO</td>
<td>No comparable is required in PIM</td>
</tr>
<tr>
<td>15</td>
<td>16</td>
<td>Exclusions / Inclusion from income &amp; Expenses</td>
<td>Being transaction based tax it will be covered by PIM</td>
</tr>
<tr>
<td>16</td>
<td>18</td>
<td>Markup Margins</td>
<td>No comparable data is required in PIM</td>
</tr>
<tr>
<td>17</td>
<td>19</td>
<td>Interest on loan</td>
<td>Being a transaction it will be covered by PIM</td>
</tr>
<tr>
<td>18</td>
<td>21</td>
<td>Multiple year data taken by tax payer, rejected by AO</td>
<td>No comparable data is required in PIM</td>
</tr>
<tr>
<td>19</td>
<td>22</td>
<td>Valuation of Equity Purchased &amp; Sold</td>
<td>Being a transaction it will be covered by PIM</td>
</tr>
</tbody>
</table>

It can be seen that the PIM will eliminate 15 reasons of disputes completely. Reason code number 6, 8, 11 and 12 may not be fully taken care by PIM.

Reason code number 8 & 12 are hidden transactions after a transaction, hence they are difficult to be taxed directly. However rules for such transactions can be made for the same. Also it is to be noted that the first transaction will be taxed in these situations. Hence the governments will be losing only a small portion of revenue in PIM.

Reason code number 6 & 11 are related to the intentions of the tax payer. If a tax payer is bent on tax avoidance, and purposeful noncompliance, then any model of taxation will fail. Hence these disputes cannot be taken care by any method of taxation and require punitive action only. A method similar to current investigation

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and assessment mechanism may be able to take care of such disputes. Also these are factual disputes.

Considering the fact that the different countries will have different tax rates, hence it will be important that the rate of taxing international related party transactions will have to be different. Hence it is also proposed that considering the various considerations other than revenue considerations the government will have to come up with country wise taxation rates for all such related party international transactions to be taxed using PIM.

### 5.4 Areas for further study

Further study into relevance and implementability of the price irrelevance model in India and across the world has to be done so as to present it as an alternative method of taxation for international related party transactions. Rate at which such tax will be viable will also have to be studied. For this historic data will have to be taken at a national level and models and combinations worked out which will keep the MNC’s interested in business in the economy and the governments also get their due tax. Bilateral and multilateral agreements along with the external policy of the government will have to be studied for this purpose.

Under the current mechanism of taxation, a regression model based on the reason wise addition needs to be studied and made so as to create a projection about the additions that can be made by the tax authorities in a particular tax payer’s case creating a certainty in the tax liability payment. Similarly the tax authorities can use the model to estimate the tax collection that may happen to give them a better projection for the tax collection. However it has to be noted that this model will have to be periodically retested with current data since there may be changes in the behavior patterns of the tax payer, when it comes to declarations of ALP over a period of time.
The international TP issue being related to transactions in foreign currency or flow of currency in other country, the BoP of the country is bound to be affected. In one of the papers authored by the researcher, indication of the impact of international TP is highlighted. However the in-depth study into this subject is required so as to have an understanding about the magnitude of the problem and to know if that is one of the reasons for a negative BoP situation of many countries.

Similar to the BoP being affected, the TP similarly if this quantum of funds would have been moved through currencies, there will be definitely an impact on the currency rates. Further study into this aspect is required to understand the same.

The economy being largely affected by the international TP including that of the currency rates and the BoP situation, it becomes imperative that studies are conducted about the impact of TP on various economic factors, which includes income distribution, inflation, growth of a particular sector of the economy, etc.

The MNC’s are increasingly investing in developing countries. However with all the global objectives of these MNC’s one has to study the real benefit to the host economy in which they invest. Is the FDI in the economy going to benefit the economy in long run is a matter of research, especially when the additions to the income on account of international TP are on such a large scale.