EXECUTIVE SUMMARY

Introduction:

Trade is the heart of economy. The health of economy is judged by volume and growth of trade. The price between related parties is likely to be a price decided for convenience of related parties which is commonly known as transfer price. This arises when the group companies, sister companies, subsidiary companies or parent company transact with each other. This may also be between relatives. When these transactions are across political borders, the price of such transactions is called international transfer price.

International transfer price is in existence for a very long time; In fact it is in existence since the multinational organizations come into existence. As the international trade grew with time this strategy of transfer pricing as a risk management tool and the fund management tool also became an important one for the MNC’s. These MNC’s with their monetary strength started to use the geographical and regional advantages so as to ensure the maximization of their global shareholder wealth. In using these there were a lot of hurdles and risks that the MNC’s were carrying, and the same had to be managed by them. There were several risks that needed to be analyzed and then avoided or priced or cared for.

Governments have a larger responsibility of welfare for the citizens of the country. There are various activities and areas which demand government spending, and for this purpose the governments require revenue. Income Tax collection from business in the country is a fundamental source of revenue for governments. Transfer pricing is a strategy through which revenue and income is moved by the MNC’s out of the country, meaning the income to that extent escapes the tax system of the host country and hence less tax for the country. Collection of all rightful tax is a matter of right for the government, whether capitalist or socialist. This is also essential for good governance.
International transfer price brings us to a standoff with one side MNC’s looking for global PAT maximization, which at times clashes with the revenue requirements of the governments, and the governments looking for collecting all the rightful tax they can, for their expense requirements.

The above two principles of welfare and capitalism bring us to the standoff. In case of international transfer pricing where in a lot of stake is there for countries in form of loss of revenue and similarly at stake is the global profits for the MNC’s. Capitalism and welfare standoff in front of each other in form of opposing objectives of the MNC’s and the objectives of the governments. This brings natural clash and dispute in the philosophy of working of the MNC’s and the governments.

Transfer Pricing being one of the issues of substantial dispute hampering international trade, OECD has tried to come up to resolve the standoff by coming out with the guidelines for transfer pricing for MNC’s and Tax Administrators. OECD member countries have accepted to adopt separate entity approach and to implement the same intra-group transactions are to be taxed on the basis that they act at Arm’s Length in their dealings with each other, which will provide fair taxation and revenue to various countries. In its Seoul declaration, OECD has identified transfer pricing as one of the significant concerns for tax jurisdictions. This is even more concerning given the fact that the international related party trade is on a constant rise. This arises due to arbitrage opportunities due to tax rate differential. India has adopted the guidelines with slight modifications. The perspective of the tax payer and the tax authorities is very vital to reduce or eliminate the disputes. This brings us to their intentions, and hence to the principles for which the two are there.

The study finds the functional areas and reasons for dispute amongst the tax payer and the tax authorities using the TPO orders and interviews of the tax payers, tax practitioners and the tax authorities. An attempt is made to find intentions behind the transactions. Also reported cases decided by the honorable courts and tribunal and interviews have been relied upon for finding intentions. Further an indicative new procedure of taxing for international related parties is also elaborated.
**Literature Review:**

It is very evident from the literature that international transfer price is no doubt used for strategic purpose. It is used by the MNC’s as a tool for managing their tax liabilities and for their fund management. It is used to acquire market share by predictive pricing and justify the pricing by cross subsidization of the products. It is also a very important tool for managing the local risk by moving funds out of the country and hence managing risk. Transfer pricing is also used as a tool for transferring funds when such a movement is restricted by law. Thus making it a vital part of the business strategy. However it is also suggested through the literature that transfer pricing is also used for efficient resource allocation at global level, and hence forms very important part of the strategy of MNC’s.

Transfer pricing is also used as a tool for management control. Divisionalisation and creating profit center helps in better autonomy and hence control. In turn transfer pricing is used for better utilization of group resources and can be also used for tax avoidance to maximize profits.

A lot of literature conforms that international transfer pricing is used by the MNC’s for the purpose of tax management, and that the trade is designed in such a way that the tax liability is reduced. Macro-economic factors also play a vital role in this situation which affects the strategy of the MNC’s. That MNC’s try to create equilibrium at international level and that non-compliance to ALP is a part of creating equilibrium, along with taking advantage of tax arbitrage that is possible due to difference in corporate tax rates in two countries where in the MNC operates. All this makes international trade to be driven by forces other than that of the market forces, and that subjectivity in the legislature helps in MNC’s to take advantage.

It is also found that the tax compliance is a big risk perceived by the MNC’s and that is one of the reasons that they resort to use of transfer pricing to reduce tax liability to mitigate the risk of difference in interpretation by the tax authorities for ALP and hence the arising penalties.
Literature also highlights subjectivity in the legislation and the guidelines are causing disputes between the tax payer and the tax authorities. This is especially true in case of intellectual properties and intangible assets which are unique and no comparable are possible to be used for determining the ALP. Thus the current legislation is not in a position to take care of this aspect. Alternative methods available under the accounting standards are not always used by the tax authorities and hence adding to the disputes. Debt guarantee and benefit arising out of it is also a part of dispute given by the literature.

There are landmark cases decided by the honorable Supreme Court of India and other High Courts in the country which talk about the intention behind international transactions. The courts have laid down that if the intention of the tax payer behind the transfer between related parties across the international boundaries should not be that of tax avoidance, however if the tax avoidance is incidental to other intention and objectives, and this creates reduction in the tax liability then the tax payer is not to be held liable for tax evasion.

Literature emphasized the need for evaluations into the intentions of the tax payer behind international transfer pricing. There are a few reasons and one of the prominent out of the same is reducing the global tax liability. On the other hand the tax authorities require collection of revenue for the purpose of governance and hence maximizing the tax collection is the apparent intention. This brings contradiction in the intentions of the two, which becomes one of the reasons for disputes. There is however very less or no literature available which talk about the basis of disputes and areas of disputes that is prevailing amongst the tax payer and the tax authorities. It is found that there is a requirement for in-depth analysis of the reasons of dispute amongst the tax payer and that of the tax authorities. Also the areas of dispute have to be identified and then analyzed. Hence a critical analysis of controversies in this area is warranted and attempted in this research work.

**Research Methodology:**

This study is essentially a qualitative study. It is done with a combination of case study method and phenomenology.
The study is intended to find the reasons for the disputes between the tax payer and the tax authorities. Interviews for a large sample are practically not possible and hence orders passed by the Transfer Pricing Officer (TPO) were considered over a period of time. Each order in itself is a case study since every year the TPO treats the audit as a new case. The orders have explanations by the tax authorities for their decisions and arguments of the tax payer upon the same. Hence it is a phenomenon that is studied through a limited purpose case study.

Each order of the TPO is critically examined and meaningful statements indicating disputes between the tax payer and the tax authorities are derived. These statements are then generalized into commonly occurring reasons of disputes. The TPO orders are expected to have more than one such reason, and hence technique or horizontalization is used to classify the statements into relevant reasons of dispute. Further such classification of each case into the reasons identified is being used to arrive at a logical conclusion. Details of the same are elaborated further in this chapter.

This study hence tries to combine the advantages of case study and the phenomenological methods so arrive at a mix method under phenomenology which uses basics of phenomenology with a combination of case study method. Detailed process used is elaborated further in this chapter.

**Statement of Problems:**

OECD has given guidelines for tax administrators and the tax payers for international transfer pricing legislation implementation. The Indian legislation is on same lines as that of the OECD guidelines. There are different ways of implementing the method prescribed in the legislation and the legislation holds all this valid, in all circumstances and situations. This makes the legislation highly subjective and free to be interpreted flexibly by tax payer as well as the tax authorities.

If intended, the tax payer can use the text of the legislation to his benefit and interpret the same citing its validity in the legislation to reduce his tax liability, and the same
can be done by the tax authorities for increasing the taxes they collect. This flexibility in interpretation throws open a window giving many areas for causing disputes amongst the two.

There is a very thin line between the legislation being interpreted in the correct text and intended spirit, and correct text but incorrect spirit. This hence causes disputes and the root cause of these disputes can be traced in the subjectivity prevailing in the legislation. The legislation taken in correct text and correct spirit can cause disputes on the subject matter and the facts of the case, however if the intent is to avoid tax by the tax payer or to collect extra tax by the tax authorities, the interpretation can be in correct text of the legislation but the spirit in the legislation is lost. Finding the intent behind the interpretation of the text of the legislation thus becomes very important part of understanding the reasons for disputes between the tax payer and tax authorities. Understanding of the intent of the both is very important to understand the reasons for the dispute.

Objectives of Research:

1. Critically examine the approach of income tax department and the assesses towards transfer pricing.
2. Critically examine if the OECD guidelines and Indian legislation are taken in correct sprit or correct text.
3. To develop a tentative method for reduction or elimination of disputes for transfer pricing.

Hypotheses:

1. The approach of Income Tax department and that of the tax payer towards transfer pricing is contradicting each other.
2. The OECD guidelines and the Indian legislation are not taken in the intended spirit.
3. Subjectivity in the legislation is causing controversies among Income tax department and the tax payer.
Directorates of International Taxation under the Income Tax Department were approached for the TPO orders. Data was made available from six out of ten such directorates. Out of all the cases received; cases which did not have any additions to were not considered. The final count of cases spanning AY 2002-03 to AY 2008-09 was 1070 cases from 682 companies.

Findings:

There are 19 reasons identified for the purpose of classification of points of dispute between the department and the tax payer for acceptance of ALP. These above reasons were further divided into reasons for disputes arising due to taking legislation into incorrect spirit by either tax payer or tax authority, and reasons for disputes arising due to having difference of opinion about the subject matter of case or facts of case.

Reasons for disputes arising due to taking legislation into incorrect spirit are as follows:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Reasons</th>
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<tbody>
<tr>
<td>1</td>
<td>Agreement on comparable</td>
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<tr>
<td>2</td>
<td>Basis of determination of ALP</td>
</tr>
<tr>
<td>3</td>
<td>Application of Method for ALP</td>
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<tr>
<td>4</td>
<td>Deliberate mess up by Tax Payer on allocation</td>
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<tr>
<td>5</td>
<td>Corporate guarantee, its cost &amp; Notional Interest</td>
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<tr>
<td>6</td>
<td>Basis of adjustment to expenses/income</td>
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<tr>
<td>7</td>
<td>Deemed Loan</td>
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<tr>
<td>8</td>
<td>Royalty Payment/Brand Fee</td>
</tr>
<tr>
<td>9</td>
<td>Interest free loan</td>
</tr>
<tr>
<td>10</td>
<td>Comparable not available at time of filing taken by AO</td>
</tr>
<tr>
<td>11</td>
<td>Interest on loan</td>
</tr>
<tr>
<td>12</td>
<td>Valuation of Equity Purchased &amp; Sold</td>
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</tbody>
</table>
Reasons for disputes arising due to having difference of opinion about the subject matter of case or facts of case are as follows:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Reasons</th>
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<tbody>
<tr>
<td>1</td>
<td>Product &amp; business differentiation adjustments</td>
</tr>
<tr>
<td>2</td>
<td>Reasons for adjustments to ALP</td>
</tr>
<tr>
<td>3</td>
<td>Share application money as loan</td>
</tr>
<tr>
<td>4</td>
<td>Documentation, evidence</td>
</tr>
<tr>
<td>5</td>
<td>Exclusions / Inclusion from income &amp; Expenses</td>
</tr>
<tr>
<td>6</td>
<td>Markup Margins</td>
</tr>
<tr>
<td>7</td>
<td>Multiple year data taken by tax payer, rejected by AO</td>
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</tbody>
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**Other Findings:**

- The TNMM cannot be implemented without adjustments.
- Lack of consistency in thinking and approach on part of the tax authorities.
- There is lack of clarity amongst the tax payers about how to select comparable.
- Strong indications are found that the tax payer's intentions are to manage tax liability.
- Strong indications are found about the legislature taken in incorrect spirit by the tax payer.
- Strong indications are found about the subjectivity in legislature is creating disputes.
- Legislature fails to give a method for taxation in case of unique transactions.
- There is lack of clarity about the pricing methods used for TP amongst the local officials of the MNC’s.
- The tax practitioner is not given the computation basis and the intentions behind the TP determination.
• TP is one of the most cost effective methods of moving funds across the political boundaries of a country.
• TP is strategic decision and the legislation is not considered before making these decisions.
• Tax payer is intending to avoid all possible tax and for this purpose is not willing to settle the disputes till end of all available judicial system.

From the findings and the qualitative data it is concluded that all the 3 hypotheses made are accepted.

Taxing Internationals related party transactions is a clash between two philosophies: Capitalism and welfare. The MNC’s are capitalist motivated and have to maximize their global PAT, whereas the governments require taxes for welfare purpose. These opposing principles are the basis of all disputes relating to International TP at philosophical level.

At the implementation level, the intentions of the tax payer are to avoid all possible tax and that of the tax authorities is to collect all rightful tax. The legislation is made up with a background of self-compliance and hence loosely knitted, giving rise to multiple interpretations of facts, which are all correct in text and hence there are a lot of disputes. The subjectivity in the legislature is causing disputes. There is a requirement of simple and objective method for taxing international related party transactions.

Other conclusions:

• Global databases may be used where finding comparable is difficult from local databases.
• Methods of valuation of intangible assets may be used to decide appropriate payment of royalty and commission for agency services.
• Cost based methods may be used for computation of ALP for head office services.
• Selection criteria for comparable by the department should be declared in advance so as to have better compliance by the tax payer.
• TP is cost effective hence preferred tool for fund transfer across boundaries.
• International TP has an impact of currency flow and hence the BoP of the country.

**Alternative method of taxation:**

Price irrelevance model is introduced through this work at a conceptual stage which will have to be further studied, which will substantially reduce the disputes and be more objective in its approach.

There is a clear arbitrage opportunity currently 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. 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 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 of tax payer.

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 (PMI)**.

*Use of the Model*

The PIM basically eliminates the computation of ALP. Hence the disputes arising due to agreement on ALP are completely eliminated. It is 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.

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 transactions to be taxed.