CHAPTER 1: INTRODUCTION

1.1 OVERVIEW

Transfer Pricing has been one of the most fascinating and thought-provoking fields in the area of International Taxation Laws. In layman terms it is the practice whereby companies reduce their profits and/or increase expenses on account of purchase of goods or services from foreign located group companies, so as to reduce their worldwide tax liability. Countries hosting Multinational Companies (MNCs) and Trans-national Companies (TNCs) have responded to these potential reduction in tax revenues by unilaterally introducing specific transfer pricing and anti profit-shifting rules, i.e., rules that restrict an MNC group company’s ability to shift profits abroad to another group company. While few countries, like USA, had some rules in place, serious coordinated initiatives began with the European Commission (1997) and by the OECD (1998 and recently in 2013); even India joined the efforts in the last few years, so as to restrain tax ‘base erosion and profit shifting’ (BEPS). Despite unilateral implementation and international initiatives as per the theoretical literature on profit-shifting, it is not clear whether such restrictions are generally beneficial for the imposing countries.

Various means are adopted to reduce the taxable profits. Subsidiaries of multinational firms located in high-tax countries tend to borrow from group entities located in low-tax countries, which enables multinationals to save taxes since the taxes avoided through the interest deduction at the high-tax location exceed the taxes on interest income at the low-tax location. There is also evidence that firms adjust prices for intra-group trade, so called transfer prices, to lower the tax base in high-tax countries, i.e, affiliates located in low-tax countries may charge high prices for intra-firm deliveries and affiliates located in high-tax countries may charge low prices.
The extent to which this is possible, however, varies across industries. Intra-group transactions related to royalty payments, R&D payments, price or ownership of intangible assets, or advertising expenses are found to be particularly tax-sensitive. Certain circumstances like lack of appropriate regulations, non-observance of the arm’s length principle give rise to disproportionate advantages at the level of stakeholder companies. The profit-allocation amongst the associated enterprises and subsidiaries gives rise to tax-planning and consequentially to anti-profit shifting rules.

With regard to profit shifting, host countries have implemented measures aimed at restricting profit shifting through rules limiting the scope for manipulation of transfer prices (called transfer pricing)\(^1\).

**The availability of such options also depends on the responses of other countries.** On the other hand, imposing restrictions may still, regardless of the responses, not be able to provide the desired affect if it is not applied uniformly and by each impacted jurisdiction.

### 1.2 OBJECTIVE

**The main aim of the study is to elucidate the basic features of Transfer Pricing and Anti-Profit-Shifting measures used by India, with special reference to the methods and comparables, and compare their application with the set of Countries under comparison – US, UK, South Korea and Mauritius**

While analysing the same it is essential to take into account the fact that there are varied tax benefits, different rates of tax, and other such ancillary benefits provided in different jurisdictions. **The comparative analysis revealed the convergence and/or divergence of the rules operating in the different countries.** To understand that further, one has to detail out the comparables used, adjustments made in the sets of ‘International Transactions’ between ‘Associated enterprises’.

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The analysis would be done by following a two-pronged approach –

One by analysing the transfer pricing provisions and the select use of methods along with the comparables;

And second vide a comparative study of the specified countries qua One.

The significance of the study lies in the fact that with India being a developing and fast-growing economy, the certainty and simplicity of the tax provisions, especially the transfer pricing regulations, are imperative in order to grow the foreign direct investments, which constitute a major part the economy. But with intermittent and haphazard fluctuations in the policies relating to transfer pricing, the investor confidence will surely decline. Thus, *establishing whether uniformity is practised in the application of transfer pricing and anti-profit shifting rules to similar or different International Transactions has never been more important. Establishing the divergence possesses both theoretical and practical value in light of the desirability to converge towards a unified TP regime.*

1.3 CONCEPTUAL CONTEXT

Tax policy has remained under pressure to restrict tax planning carried out by multinationals trying to take advantage of the differences in the international tax-rates which provides them with the incentive to alter the profits’ allocation between the different group companies of an MNC. The study will comparatively analyse the Transfer Pricing regulations qua the aforementioned countries.

Further, though these measures have been put in place to restrain their ability to shift profits, are these short term gains by tapping corporate tax blinding the tax authorities from the long-term loss of healthy foreign investment flows into the host countries due to divergent tax regime? Is this being penny wise pound foolish?

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These questions propel a scrutiny of the existing divergence in the provisions and their respective application in context of the countries’ *Lex Loci.*

The study elucidates upon the Transfer Pricing provisions and the various methods applicable to the set of international transctions. It details out the 5 basic methods – Comparable Uncontrolled Price (CUP), Resale Price Method (RPM), Cost Plus Method (CPM), Profit Split Method (PSM) and Transactional Net Margin Method (TNMM), and their choice of application as MAM (Most Appropriate Method) to the given set of international transctions.

Profit-shifting restrictions may exert adverse effects given the differential use of method and/or comparables for same set of ‘International Transactions’, which may adversely affect, for example, the sensitivity of investments, due to the underlying uncertainty.

*Against this background, the research has analysed these underlying differences inherent in the transfer pricing regimes operating in individual countries and suggested possible convergence options, based on the said analysis.*

The analysis focuses on anti profit-shifting measures directed against transfer pricing, which have been identified as key mechanisms for profit shifting in recent literature.

The weakness in the transfer pricing rules arising out of its divergent application across different jurisdictions has led to its rampant misuse revealing and creating opportunities for Base Erosion and Profit Shifting (BEPS), and requires a robust initiative towards convergence to restore confidence in the system, starting with ensuring profits be taxed where the economic activities take place and where the value is created - referred to as the place of economic incidence.\(^3\)

\(^3\) ‘Concept of incidence of economic activity’. See *infra*, Chapter 2.
In moving towards the goal of a uniform transfer pricing regime, one of the biggest and most ambitious plan on behalf of the OECD was initiated on September 2013,\textsuperscript{4} which brought into inception the BEPS Action Plans comprising of 13 action reports, involving a reinforced set of regulations to be uniformly followed; and has received unprecedented support from more than 60 countries, who have incorporated some or most of such changes into their local and regional legislations. Figure 1.1 below summarizes the changes brought about.

\textbf{Changes to the international taxation landscape}

- **Action 1**: Address the tax challenges of the digital economy
- **Action 2**: Neutralise the effects of hybrid mismatch arrangements
- **Action 3**: Strengthen CFC rules
- **Action 4**: Limit base erosion via interest deductions and other financial payments
- **Action 5**: Counter harmful tax practices more effectively, taking into account transparency and substance
- **Action 11**: Establish methodologies to collect and analyse data on BEPS and actions addressing it
- **Action 12**: Require taxpayers to disclose their aggressive tax planning arrangements
- **Action 13**: Re-examine transfer pricing documentation
- **Action 14**: Making dispute resolutions more effective
- **Action 6**: Prevent treaty abuse
- **Action 7**: Prevent the artificial avoidance of permanent establishment status
- **Action 8**: Consider transfer pricing for intangibles
- **Action 9**: Consider transfer pricing for risks and capital
- **Action 10**: Consider transfer pricing for other high-risk transactions

\textit{Figure 1.1}

\textit{Source: <http://www.skpgroup.com/data/resource/skpinsights_oecd_sbaseerosionandprofitshifting_beps_project_.pdf>}

\section*{1.4 RESEARCH PROBLEM}

The comparative analysis of the countries, will aim to show how the restrictions and regulations are differently affecting the international transactions.

CHAPTER I

The first step towards solving the problem is – determining the problem. As aforementioned the process of arriving at a (correct) price for the (International) transactions entered into between intragroup (Associated) Enterprises, is the issue/problem that the tax authorities of the world have been grappling with. Since transfer pricing is not an exact science, technically speaking there is no right or wrong price that can be applied universally.

The diverging tax practices in the transfer pricing arena across different jurisdictions highlight the desire and preference of the tax authorities to reach to an exact price – the Arm's-Length Price, ALP – which they perceive as the correct one. Instead the endeavour should be to have uniform standards for determining the method to be followed and the comparables to be chosen for different set of transaction/s, even though it may may not necessarily yield the same price in the different set of international transactions of same/similar nature.

Thus to understand the determination of the actual transfer price, the study aims to first layout the existing transfer pricing provisions along with the transfer pricing methods used by India and the countries chosen for comparison, to arrive at the Arm's-Length Price. It also aims to highlight the existing procedural requirements like documentation and APAs (Advance pricing arrangements) in the four countries under comparison.

The existing comparison will draw out the problem of divergence in the substantive and procedural regulation/s relating to transfer pricing which potentially ead to have led to cases of zero taxation or double taxation, due to either the constant and continuous ‘Transfer MIS-Pricings’ carried out by the Multinational and Trans-national group of companies or zeal of the tax authorities.

This persistence of application of differential and divergent transfer pricing provisions across the globe has resulted into growing acts of ‘Transfer MIS-Pricing’.

Companies and enterprises take advantage of the stark differences and try and maximize the value of the group’s overall profits, for example, by reducing tax liabilities by piggybacking on the differences in local tax rates, or by reducing profits of a group enterprise.
One of the recent ways to carry out BEPS, used by different companies hosted in different jurisdictions, is by shifting profits based upon the location of intangibles being used in the international transactions. Location savings is another such example and has been discussed in detail in the Chapter hereinunder.

There are several gaps leading to express deviations in the Transfer Pricing provisions forming part of the Indian Taxation Statutes as compared with other transfer pricing regimes around the world, which can be removed after analyzing the codified law. Reiterating at the cost of repetition, the researcher has analysed these underlying gaps and differences inherent in the transfer pricing regimes operating in individual countries and has suggested possible convergence options, based on the said analysis.

This study having discussed the above, would also have to further analyze it on a comparative scale. For this purpose comparison is sought to be drawn between 3 types of countries –

1. Countries having developed and well established TP rules;
2. Developing countries having developing TP rules;
3. Countries having no TP rules.

1.5 LITERATURE REVIEW

The literature review lays out the Indian Transfer pricing provisions that are put under comparison qua other countries’ Transfer pricing provisions, which aims to show how the restrictions and regulations are differently affecting the international transactions.

Starting with INDIA, Sections 92 to 92F of Income Tax Act, 1961 deal with the Indian transfer pricing rules. The CBDT (Central Board of Direct Taxes) has set up a separate Transfer Pricing Cell for conducting transfer pricing audits. (Wahi, 2013)

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6 Discussed in detail herein under Chapter 6 for detailed Discussion on transfer pricing of n account of Location Savings; See infra, Chapter 6.
Perhaps no other country has had a busier decade in terms of transfer pricing than India (Deloitte, 2015).

Though it has kept pace with the advances in the transfer pricing regulations as envisaged under the TP regulations of countries like US and UK (PwC, 2015), but has been drifting away from a uniform set of Transfer pricing provisions – one such example, showcasing the drift being of Location Savings⁷, as highlighted under UN TP Manual (UN TP Manual, 2013) which, though the Indian courts, affirming the world’s view (Whatson Pharma, Mumbai Tribunal, 2015), have held it being a mere factor while choosing comparables and not the only determining factor for a country like India, but the tax authorities and the government have taken a contra view, in contrast with the view of the rest of the world (OECD Guidelines, 2010).

In **MAURITIUS, Cayman Islands and Singapore**, NO standing transfer pricing regulations exist. There are several groups that have entities established in these countries, through which they route the profits to reduce the worldwide tax incidence (KPMG, 2013). For instance Microsoft avoided paying 6.5 Billion dollars by transferring the money that they earned to a legal tax haven like Cayman Islands.⁸

OECD has now come up with recommendations to initiate the alignment of the divergent Transfer Pricing Rules of the countries.⁹ Also, APAs (Advance Pricing Arrangements) between the taxpayer and the tax authority in its jurisdiction as well as between the taxpayer and tax authorities in various tax jurisdictions can be obtained in order to secure the enterprise/s from the risk of the different view of tax authorities in application of the transfer pricing policy (PwC, 2015 and E&Y, 2016).

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⁷ For details see *infra, Chapter 6, “Location Savings”*.  
See real-life examples of tax avoidance by transnational corporations (TNCs) like Google, Amazon, Starbucks and Microsoft through transfer pricing practices has come under intense scrutiny. This equally effects the developing countries TP practices as well, where transfer pricing has long been an issue for host economies.  
One of the challenges faced worldwide is that of the transfer pricing compliance which includes not only the divergence of the rules from country to country, but the variance in the enforcement practices as well (Saughter and May, 2016). Pertinently, the transfer pricing provision of a country like India does indicate whether a given transfer pricing methodology can be adopted for an international transaction but it throws little light as to which of the methods are preferred (CA N Jain, 2014).

The Indian cases of Tally Solutions (Bangalore Tribunal, 2012) and EKL (Delhi Tribunal, 2012) Appliances do provide some indication towards a possible a convergence, atleast at the behest of the judiciary. The prospective Indian implementation of the CbC Reporting Requirements also may fuel speculation towards a possible convergence trend and a move away from divergent practices (OECD BEPS Action Plan, 2013).

1.6 RESEARCH QUESTIONS

The comparative analysis will put to test the following central questions of the research study:

What methods are prescribed under the Transfer Pricing regulations and which of these methods are applied to the given set of international transactions between two associated enterprises?

Whether the countries whose Transfer Pricing regimes are being compared use similar or different methods, for the same set of ‘International Transaction/s’?

Whether the countries under comparison use similar or different/divergent Transfer Pricing regulations & provisions?

What uniformity in the provisions of the compared countries and their respective application can reduce the disparity, in a move towards convergence.
1.7 RESEARCH METHODOLOGY

The analysis employs a qualitative data approach, to be used in comparatively analysing the different/divergent transfer pricing provisions applied to the international transactions.

The research is mostly Doctrinal in nature. The primary resources consulted are -

- Transfer Pricing Regulations of India and the 4 other countries (US, UK, South Korea and Mauritius).
- Judgments rendered by Indian Courts and Courts in other jurisdictions.
- OECD Guidelines on Transfer Pricing regulations.
- OECD BEPS Reports/Action Plans and UN TP Manual/s.

Secondary resources consists of books and articles from journals, magazines and also from web resources. Legal Databases of SCC Online, SOLO Library (Oxford), (Westlaw UK and US), Taxmann.com, have been used.

Existing legislations qua the documentation requirements and APA regulations forming part of the Lex Loci of these countries have also played a guiding role in the study.

The study has analyzed these resources in combination with information on the Transfer Pricing rules enacted by the host countries of foreign subsidiaries in these four countries, including India, over last few decades, to examine whether and to what extent these measures have been differently applied in the concerned jurisdictions.
1.7 CHAPTERIZATION

The study is in six chapters as follows, apart from the introduction.

2. TRANSFER PRICING : UNDERSTANDING THE CONCEPT:

In this chapter the basic concepts relevant to the Indian transfer pricing regime will be discussed. These would include concepts of ‘International Transaction’ and ‘Associated enterprise’, ‘related party’, as also ‘deemed associated enterprise and deemed international transaction’. The chapter furthermore discusses the documentation requirements and Advance Pricing Arrangements (APAs) as prescribed under the Indian transfer pricing regulations, which will assume significance, when comparing with other countries’ documentation requirements and APAs.

3. ALP and MOST APPROPRIATE METHOD :=

*CUP, RPM and CPM*

This Chapter will focus on the use of the five methods and on the choice of methods adopted and comparables used for specific ‘International Transactions’. The various methods of computing arm’s length price are: (a) Comparable uncontrolled price method (b) Resale price method (c) Cost plus method (d) Profit split method (e) Transactional net margin method. The 1st three methods, also known as the *Traditional transactional methods*, are discussed in this chapter - Comparable uncontrolled price method, Resale price method and Cost plus method. The applicability of these methods to the specific international transactions has been considered, as well as the ‘commercial rationality’ test.
4. ALP and MOST APPROPRIATE METHOD :=

**PSM and TNMM**

This Chapter deals with the *transactional profit methods*, i.e. Profit split method (PSM) and the Transactional net margin method (TNMM) and also discusses the Most Appropriate Method. The Chapter will give due weight to the choice of methods while being made applicable to a specific transaction as per the Indian jurisprudence.

5. **COUNTRIES**

Under this chapter the comparative transfer pricing provisions relating to associated enterprises, related parties, transfer pricing methodology, comparables and adjustments of the four countries under comparison – United States, United Kingdom, South Korea & Mauritius – have been laid out, spelling out the divergences and/or any similarities in the applicability and adoption of methods to the international transactions. The documentation requirements as well as the advance pricing arrangements of the four countries under comparison, have also been laid out.

6. **Comparative analysis of Individual topics / issues in India and other Countries**

This chapter discusses the concept of some of the recurring issues related to a pricing pricing worldwide like Intangibles and Location Savings *affecting almost all multi-national groups*. Landmark Decisions of the two topics have been comparatively studied. In relation to the use of intangibles and location savings, and how and when would the Transfer pricing rules be applicable to the same has been laid out almost entirely by judgments of the Courts and Tribunals of both India and the United States.
7. **CONCLUSION**

The research thus concluded, has pointed out areas of disparity and divergence in the transfer pricing provisions and their application. The researcher has provided suggestions to reduce or eliminate these disparities in the transfer pricing rules and provisions between countries with regard to their applicability to international transactions.

The entire research undertaken has led to an indispensible requirement of moving towards convergence of the international and domestic laws under a single umbrella law. The ultimate objective is to get uniformity in the application of the transfer pricing provisions for a more certain and simpler transfer pricing regime.