Rationale and Some Issues on Transfer Pricing

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< EXECUTIVE SUMMARY >

◆ What is transfer pricing ? Why is it implemented ? Rationale and the underlying principles of transfer pricing. An extension of VAT in transfer pricing. Bridging of fiscal v economic tax base. The multiplier effect of transfer pricing. Issues - Method of accounting vs arm's length price, Transactions, Computational irrationalities, Documentation, Slump sale, Customs valuation its relevance to transfer pricing, Disturbing other party's tax position, Transparency v computation, Force of attraction under DTAA, TDS disturbances, Expenditure audit, Legal decrees, Share valuation other assets/capital gains in transfer pricing, Regulatory pricing. The area of transfer pricing is very new to India and is evolving. Given the nascent law in its ramifications, the article examines some economic aspects and some issues arising out of the TP regulations in India.

The area of transfer pricing is new to India being a creation of the Finance Act 2002. Needless to mention that the law being nascent is likely to create umpteen litigations and interpretational jeopardy in the days to come. This article examines some aspects of it and discusses some critical issues on the area of Transfer Pricing. The article examines in two parts the first one being the rationale and the second one addressing some issues.

RATIONALE:

Why Transfer Pricing ?

Question that often rises in all our minds is why is there something called as Transfer Pricing. While it is known that each nation has its own:

a) Economies of operations
b) Natural and artificial resources
c) Entry and levels of factors of production
d) Ecological differences
e) Currency and exchange related differences
f) Cultural and Industrial implications on business
g) Demographic irrationalities

On account of the above and a host of various innumerable factors, there is likely to be difference of tax rates amongst nations. The prime reason of the tax rate differences arise out of factors of production, capital flight regulations and economical strength is more or less an established fact.

It is the difference of this tax rates amongst nations which can create a fictional tax arbitrage, to combat transfer pricing law is in vogue.

A simple illustration would exemplify this.

For instance there are two countries called "Utopia" and " Nowhere" both having a tax rates for corporates at 40% and 10%. Company "A" is incorporated in "Utopia" and Company "B" in " Nowhere". Assume that they are related enterprises with one being a sub-

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sidiary of the other with controlling powers.

Their Profit and Loss account reads thus for the year 2002

		Amount in USD	
Country Company	**Utopia A**	**Nowhere B**	**Group Total**
External sales	500	1000	1500
Internal Sales*	400		400
Less: Cost of Sales	700	800**	1500
Taxable Profit	200	200	400
Tax rate	40%	10%	
Taxes	80	20	100
Effective tax rate on profits			**25%**

*"A" selling to "B"

** Includes the inter group cost of sales and inter group sales are made at cost basis without any margins for simplicity

Thus by merely shifting the selling from Country "Utopia" to "Nowhere " the entire group has been possible to leverage the effective tax rate to 25%.

While the example has assumed that the entities are related the same could happen amongst unrelated parties/entities also in which case the law of transfer pricing cannot attract the same globally since the prices necessarily would be at arm's length thought creating a natural arbitrage.

It is to artificially combat the use of such arbitrage that transfer pricing law has been created especially by the developed countries who invariably have felt the flight of capital from their nations into cheaper tax nations thereby resulting in the loss of taxes for their countries.

BRIDGING OF FISCAL AND ECONOMIC TAX BASE:

The very objective of transfer pricing is that if there are related parties in an international transaction the prices in which they deal should be at arm's length so that there is no deeming of tax arbitrage being put into use by any of them.

The concept of each country to get its share of taxes is an economic proposition in relation to their economic realities.

To question the arm's length pricing is a fiscal measure since being a part of business activities.

Transfer pricing exactly tries to bridge in a way the fiscal and economic tax base in the process.

MULTIPLIER EFFECT:

While it is seen from the example that the differential tax rates create a synergy on tax savings, to what extent can an entity (whether related or unrelated) can make use of this transfer to reduce taxes of course, subject to other things being the same is a situational study of the entity specific position.

Assume that the tax rates across the globe is the same say 20%, then there can be no real tax arbitrage in the process (except on pricing/exchange adjustments arising if any and margins).

By adopting tax/profit shifts from higher tax jurisdictions to lower tax Jurisdictions the entity can go on building the profits (maximization of wealth principle). In such case the multiplier concept holds very true for transfer pricing.

The multiplier again would be limited and dependant on,

a) Tax rates prevailing in each shift the incremental saving
b) The quantum of corpus that is shifted each time

The idea of this portion is to primarily highlight the multiplier effect being there on transfer pricing in which case applying the law all the more becomes more complicated across the globe.

Re-incarnated VAT:

The logic of transfer pricing stemming from the fact of shifting of profits across countries does it not really bring a logic of Value Added Tax (to the extent of the value added price in the transfer computed at arm's length) amongst countries ? Indeed it is, but for the subtle distinction that VAT till date is to do with indirect taxes than with direct taxes.

Indian Transfer pricing regulations:

The Indian transfer pricing regulations are enshrined in section 92 to section 92F read with rules 10A to 10E of the Income tax act and the Income tax rules. The intention of this article is to touch upon some basic issues arising on the area.

ISSUES ON TRANSFER PRICING:

Method of accounting:

Section 92(2) .....".for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or as the case may be, contributed by, any such enterprise....."

It is well known that the transfer pricing regulations apply irrespective of the entity status of the assessee under the income tax act.

It is also well settled law that the taxes shall be computed on the basis of the method of accounting regularly employed by the assessee be it cash or mercantile. Companies however have no choice but to go for a mercantile system due to the Companies act.

What is the position in relation to computation of non-corporate assesses who follow cash system ? The legislature has used the words " incurred or to be incurred", does it mean that the assessing officer if he computes an arm's length price on mercantile basis (taking into account the accrual of the entire liability for the entire period say for instance) can disturb the method of accounting regularly employed by the assessee.

A question apparently can arise to readers as to how will the method of accounting affect the price computation where the estimated cost defrayed is examined. To note that in services it can affect substantially.

It is again unfortunate that the computation provisions enlisting the methods also do not mention the same whether on cash basis or on accrual basis since it is likely that the arm's length price is likely to be different under both methods.

To note that there is no " non-obstante clause" in any of the Chapter X sections governing the transfer pricing law in which case there can be an interpretation that the same cannot disturb section 145 covering the method of accounting.

Also given the recent Mumbai high court decision that a non-resident can follow cash basis system also for his accounting vide Pfizer Corporation v Commissioner of Income- tax (2003) 180 CTR 319 (Bom), how is the twist going to happen in the case of non- resident assesses in so far as their Indian taxable income remains an open proposition. Even this ruling will have limited application in today's liberalized world is again a different question.

The use of the words "or to be provided" in the above section, again creates a doubt that even prospective entities entering into international transactions especially associated enterprises need to examine the transfer pricing regulations and get their accounts audited and report be furnished is perhaps a far fetched extension of the provision especially when such enterprises do not have an Advance Pricing Agreements (APA) or tax harbours as the law being new in India.

TRANSACTIONS:

A great deal of confusion is held on one aspect whether the arm's length price is to be determined into each of the individual aspects of a transaction's price or the entire price in toto. For instance in manufacturing the composition of a product can be raw material, power, ancillaries then is it required to prove the arm's length for each of the individual items or the homogenous product on the whole. The obvious workable interpretation thus would only be to the homogenous products and not to the heterogeneity of the entire parts.

Is each and every transaction required to be proved, this again is similar to initial confusion on MODVAT whether one to one co-relation for input to output is required ? The solution again would be by and large and entire gamut or the substantial portfolio of the homogenous transactions should comply to the arm's length price. Otherwise the entire task becomes a near impossible exercise.

An organization before indulging in transfer pricing would be ideal if it does an clear cut classification of the categories of the transactions and apply the arm's length principle only to those than examining the entire process or the sub-sects of it which would not only be a costly but a time consuming exercise.

A practical problem on homogeneity or heterogeneity of the transaction would arise for composite contracts. Do we take them as single transaction as a group or a divisible one. The Law again should be done practically to cover the entire substance in one contract so that the risks, rewards are all to be fused in toto than examined in parts which at times can throw a ridiculous valuation if done independently for arm's length benchmarking.

Captive consumption, if any in any product, service should be attributed at market price or equivalent unless or otherwise the captive consumption itself is a separate stand alone service done via a set up for that purpose such as BPO.

To be noted that gratuitous transactions are also

covered in any form as they are entered under transfer pricing.

Documentation:

The biggest challenge likely to arise is on the area of documentation as defined by rule 10D. The said section especially in relation to the computation of comparable uncontrolled price method reads in clause l(g) " A record of uncontrolled transactions taken into account for analyzing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;"

Clause (3)(c) " Priced publications including stock exchange and commodity market quotations;"

A perusal of the rule 10D(l)(g) has used the words "entered into" and similarly the rule 10D(3)(c) has used "Priced, publication of quotations" meaning if an entity for comparison purposes of arm's length price obtains mere quotations they may not be treated as good evidence, since the meaning of the word " entered into" would restrict its use to only actually entered transactions. This again may create some amount of confusion especially on products/services where there is no real published database of prices etc.

Capacity issue:

There are five prescribed methods currently viz.

a) Comparable Uncontrolled Price Method
b) Resale Price Method
c) Cost Plus Method
d) Profit Split Method
e) Transaction Net Margin Method

Which can be used for substantiating the arm's length price in transfer pricing.

None of the methods really appreciate or practically foresee a case where due to under utilization of installed capacity an assessee is forced to use marginal costing method, bereft of which he will not be in a position to recover his fixed costs on the used capacity vis a vis his installed capacity if absorption costing method is used. Of course the regulations do prescribe an exhaustive list of documentation and to fit into any of them is the acumen of the accountant.

Computational irrationalities:

In the five methods prescribed for computation especially in the Gross profit rationalization methods there could be a serious issue arising if the allocation or appropriation of the entity related gross profit results in a negative arm's length price. What will happen to the average price then if more than one method is used ? Do we ignore it though the same was being used consistently or as an aberration do we need to ignore it (this case can be practical if there are bases such as loan quantum, net assets, net worth, intangible asset base etc. being used as allocation parameters uniformly).

Another issue worth noting is that what if the assessee uses say two of the five envisaged methods and computes an arm's length price, can the assessing officer invoke the other methods and arrive at arm's length and disturb the profits and tax there on ? The answer seems to be yes in this case unfortunately since the onus then shifts on the assessee to prove that the prices were at arm's length.

A point worth examining that an assessee is likely to have the homogenous transactions say in a certain portfolio for a financial year. The question of arbitrage then arises against the non-arm's length price applied for the portfolio of homogenous transaction wise say a sub-set of the portfolio. In such a case having a simple average Price how would it really bench mark a single transaction with a group of the portfolio transaction especially in relation to the portfolio profit as against the rest of the transactions. Should not a weighted deduction be applied then ?

Slump Sale:

It is important to note that the regulations also cover transfer of assets (tangible property is covered in section 92B(1)) amongst associated enterprises. What will happen to the arm's length price if a parent decides to take its ailing subsidiary overseas on a slump sale. Will the price determined for the slump sale whether assets clustered or asset wise individually be deemed to be arm's length price ?

Again in the question of transfer of an asset the aspect of depreciation differential especially given the specific asset wise exemptions (for pollution/energy saving devices etc.) existing needs to be seen in reality.

Similarly transfer of assets from hyper inflationary economies are likely to pose a problem in valuing the arm's length pricing.

Customs Pricing v Arm's Length pricing:

There is often a concept that customs valuation rules provide for the computation of prices under international trade. Can they be treated as arms length price ?

To an extent we can agree to the proposition but tak-

ing into account the following perspectives.

a) Customs valuation is determined primarily in import duty valuation if there is an under declaration of the invoice while the logic of transfer pricing is shifting of profits due to tax arbitrage i.e substratum is different.
b) To use that price especially when the price is likely to be more than the declared value under customs (more likely in investigated cases if there is an under valuation) would it not mean that the arm's length price is determined is more than the customs price (reference to section 92 (3) is invited that transfer pricing cannot be applied where deductions losses are increased as against claimed deductions)
c) The methodology adopted for valuation which is prescribed by the (then) GATT rules while transfer pricing is on the OECD rules with both for a different purpose.

Disturbing of Non-resident's or other party's taxation:

A proposition arises that by examining the transactions for arm's length of an Indian enterprise can the department make use of the information to disturb the counter party's tax position in India. While it seems to be possible, there is no assurance for independent use of the data collected at one end to be used at the other end. The fact could be more relevant if examined in relation to the concept of existence of a " Permanent establishment" on the area of Double taxation which already is under the focus light with newer aspects such as e-com and server etc., being looked as PE for taxation.

Computation methodology v Transparency:

The methods adopted primarily have two rationales behind their modus operandi.

a) Prices charged are equivalent in relation to open market prices influenced by demand and supply (of course subject to the economic power of the entity).
b) The profits earned by the entity in the related transactions are normal and reasonable profits compared with similar profits in the relevance of the environment.

While the first logic seems to be much simpler, the second one especially when disclosure and transparency is not on even platform assumes a gargantuan question for evaluation in the days to come.

In a method similar to the Profit split method where the global profit of the transaction is examined and the share of the entity to the country based on risks, rewards is examined with market principles is again a question to be seen in real practical application especially given an envisaged condition of too many related entities and country existence in the arbitrage planning.

In infant businesses such as BPO etc., where the basis of pricing even if made transparent would it still be subject to arm's length vetting despite transparency and non-availability of market comparable ?

Relativity of monopoly enterprises (fortunately we do not have that many in our country) vs arm's length price of the market how is it likely to be looked especially where the position is that of a single supplier or a single vendor ?

Force of attraction rule in DTAA vs Associated enterprises:

No doubt the law has envisaged as wide a definition for "associated enterprises" in the transfer pricing regulations. The same needs to be cohesively applied in relation to the "force of attraction" rule available in most of the DTAA where the question of tax avoidance by using the treaty is dealt with. Will the concept of "associated enterprises" be disturbed in the force of attraction rule. Obviously given the provision in 92A(2) (m) (the residuary clause for associated relationship).

A practical problem again has to be envisaged in the area of consortium arrangements, Joint ventures especially when the power to tax them separately as AOP exists vide various judicial decisions under the Income tax act. In such cases again the law is likely to disturb the meaning of associated enterprises and may result at times in peculiar circumstances of income getting taxed at more than one source.

In cases of taxation of firms especially where the status of taxation differs amongst countries for instance in UK the partners are taxed and not the firm unlike in India where the firm is taxed and share of profits is exempt in hands of the partners, there could be practical issues arising out of disturbance of the arm's length price, resulting in re- opening of firm's assessments (and) or re-opening of the non-resident taxation in Indian hands and claim of DTAA etc. resulting there on.

Disturbance of TDS:

While 92(3) talks of non-application in case of enhancement of claimed expenditure or decrease of losses, can the TDS deduction if any done on account of the arm's length pricing computation be applied (since the TDS amount is akin to advance tax) While the practical side seems to be in the affirmative it could cause

some distress especially by way of interest etc., if wrongly perused.

Expenditure audit ?

A question often arises is arm's length pricing an expenditure audit ? if we go by the logic of expenditure audit the concept of accrual seems to the relevant one than cash basis discussed earlier for valuation of the ideal spend of expenditure. Given the wider width of the meaning of the definition of transactions, it is for sure that it is not expenditure audit alone in transfer pricing.

Another point worth discussing here, is the arm's length price would not only cover transactions on the debit side of the Profit and Loss account but also the credit side i.e revenues. This again puts an entity into real troubled waters since to prove rationalization of revenue the entity also may have to prove its bargaining power within the group enterprises vis a vis domestic market.

The question that whether revenues can be disturbed in arm's length has answer in the affirmative hence.

Legal decrees:

An open question remains on arm's length price in regard to court decrees especially where the decree proceeds are shared amongst the associated enterprises. A practical case for patent/copyright infringement happening in a foreign country while right of use alone in India and violation happens in India, then how is the arm's length price to be decided for such sharing of decrees legal fees etc.

Share Valuation/Other assets and Capital gains:

Again the definition has been made too wide to cover all assets and liabilities. why even a remission of cross country liability of an outstanding would have to be vetted under transfer pricing especially if they are done on a mutual consent among related parties.

What is the implication of valuation of options, futures, shares, debentures other investments if any transferred among associated enterprises ? The principles then need to evolve to address global share valuations, options pricing et al and no doubt the transfer pricing throws newer vistas for accountants.

It again seems that except share application or capital contribution rest all can be brought into the ambit of arm's length and transfer pricing amongst associated enterprises. This also means capital gains can also be subject to arm's length pricing both long term and short term..

Take the case of long term capital gains where the indexation logic itself is a deeming cost fiction created to overcome inflationary adjustments, can the transfer pricing arm's length computation again question the indexation benefit if not at arm's length price. After all the legislature can say that Chapter X is a self contained code overriding the rest of the provisions for such purposes perhaps.

Cases of short term capital losses especially if any arising out of the block of assets concept how can they be evaluated at arm's length price when the block concept again is a fiction.

Regulatory pricing/Anti-dumping/DPCO/ FEMA restrictions:

Arm's length computation has to take into its account the legal restrictions imposed such as regulated pricing, Anti-dumping duties, Drug price control order, FEMA restrictions (especially to insurance transactions where FEMA restricts Indian assets being insured overseas) is a point worth mentioning. A question if due to the restrictions if the benchmark or the prices quoted under these restrictions can be taken as arm's length price. It looks at the apparent face of it as a sound logic since the free market forces are controlled otherwise for arm's length price computation.

Issues Unlimited still welcome legislation:

While as seen above the issues if listed would keep ballooning but some where the legislators need to apply practical approach to the tax laws and not see everything from the evasionary angle or make it more complicated than it really seems to be. While principles which an accountant uses for domestic transaction valuation among related entities are good base grounds for applications to apply in a global framework still remains untested in our country. The law is devoid or tonsured or objectivity unfortunately. Despite all the issues and the propositions the transfer pricing no doubt is a welcome legislation given the winds of change blowing all across of nations to protect their tax share of the global tax wealth. As said by an eminent jurist in the initial years of this law it is true that what ever price the assessee is able to declare in good logic would get admitted as arm's length but for the fact that the accountant has not been smart enough to substantiate the arm's length price. ■