

An Article on Transfer Pricing: Global Tax Issue

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Abstract: *Transfer pricing refers to setting up of price for receipt/provision of goods or services by related legal entities of the same group. Transfer pricing study from a tax perspective is relevant for fair allocation of profits among various legal entities of MNCs incorporated/functional under different jurisdictions. The major purposes of this study are to understand the concept of Transfer Pricing and the steps required for preparing Transfer pricing Report/Documentation, to identify the risk associated with Transfer pricing and to analyze the reasons of its increasing scope nowadays. Transfer pricing in an economy is very significant to corporate policy makers, economic policy makers, tax authorities, and regulatory authorities.*

Keywords: Transfer Pricing (TP), Intergroup/Intercompany Transactions, Associated Enterprise/Related Enterprise, Transfer Pricing Documentation, Assessee

1. Transfer Pricing

Transfer pricing refers to the price applied to any intercompany transactions. These transactions can include the sales of products, the provision of a service, the lending of money and the use of (intangible) assets. For e.g. a company in United States having an Indian subsidiary transfers a product or service to its subsidiary for a price determined by the U.S Company for sale in India. This is normally less than the market price at which the product or service is actually sold in the market. The Implications of Transfer pricing comes to light when such a pricing of products or services are done to evade tax. Transfer pricing from a tax perspective is relevant for the allocation of profits between the various legal entities and branches of multinational companies. The international tax laws are regulated by the Organization for Economic Cooperation and Development (OECD), and auditing firms within each international location audit financial statements accordingly.

Arm's Length Transaction

Article 9 of the OECD Model Tax Convention is dedicated to the Arms Length Principle (ALP). It says that the transfer prices set between the corporate entities (under single ownership) should be in such a way as if they were two independent entities.

When is TP applicable?

Section 31(2) of the ITA provides that TP is applicable where:

- Any transaction/agreement has been directly entered into between connected persons/business entities with a cross-border connection;
- Any term or condition of that transaction/agreement differs from any term or condition that would have existed had those parties been independent persons dealing at an arm's length; and
- The transaction/agreement results, or will result, in a tax benefit being derived by any party to it. The term tax benefit is defined in the ITA to include - any avoidance, postponement or reduction of any liability for tax.

2. TP Documentation

Transfer pricing documentation is usually required by law. This documentation must substantiate how the intercompany business is set up and evidencing that the intercompany pricing applied would have been applied in the same way between third parties as well. Depending on the jurisdiction, this documentation should be submitted annually, where in other countries this documentation should be submitted upon request of the tax authorities or sometimes taxpayers are required to prepare contemporaneous documentation.

However, as the most countries generally follow the OECD Guidelines, the following steps are typically covered in transfer pricing documentation/report:

Steps	Includes
1) Description of the company and the group	<ul style="list-style-type: none"> • Outline of the business • Structure of the organization • Legal ownership within the MNE Group
2) Industry analysis	Description of: <ul style="list-style-type: none"> • Competitors • Market and trends
3) Overview of intercompany transactions	The amount and brief details of taxpayer's transactions with related companies.
4) Functional analysis (functions, risks and assets)	Brief description of functions that the parties perform taking into account risks assumed and assets used by them.
5) Selection of transfer pricing method	Selection of an appropriate method - Transaction vs. profit methods
6) Economic analysis	Application of selected method
7) Conclusion	Definition of arm's-length range. Some countries accept prices to be at arm's length if they fall within the range while other countries target the median.

3. Transfer Pricing Methods

- Traditional Transaction Methods (CUP, Cost Plus, Resale Price Method)
- Transactional Profit Method (TNMM and Profit Split)

CUP Method: The CUP Method compares the terms and conditions (including the price) of a controlled transaction to those of a third party transaction. There are two kinds of third party transactions.

- Internal Cup- comparison of tested transaction with the transaction where the tax payer or the other party sells or buys a particular product or services from an unrelated enterprise under similar terms and circumstances in comparable quantities and markets .
- External Cup- Comparison of tested transaction with independent enterprises selling or buying a particular product or service under similar terms and circumstances in comparable quantities and market

The Cost Plus Method: With the Cost Plus Method, the focus is on the costs of a supplier of property or services in a controlled transaction. Once the costs are known, a mark-up is being added. That mark-up should reflect the profit for the associated enterprise on the basis of functions and risks performed. The result is an arms' length price. The mark-up can be determined in two ways. The first, it can be compared to the mark-up applied by the associated supplier of property or services for comparable transactions with third parties (internal cost-plus method). If such transactions do not take place, the alternative is to look at the cost plus mark-up applied in transactions between third parties (external cost-plus method). This method is useful when tested party is supplying made to order goods to its related party.

Resale Price Method: The Resale Price Method is also known as Resale Minus Method. As a starting point, it takes the price at which an associated enterprise sells a product to a third party. This price is called a resale price. Then, the resale price is reduced with a gross margin (the resale price margin), determined by comparing gross margins in comparable uncontrolled transactions. After this, the costs associated with the purchase of the product, like custom duties, are deducted. What is left can be regarded as an arm's length price for the controlled transaction between associated enterprises. This method is typically useful to determine arm's length price of purchases made by the distributor from the related party.

Profit Split Method: First of all, the net profit of associated enterprise (AE) arising from the international transaction is computed, post which the relative contribution made by each of the AEs to the earning of combined net profit will be computed. Afterwards the combined net profit will be split among the AEs in proportion to their contributions. The sum so arrived at is the arm's length price.

The Transactional Net Margin Method: With the Transactional Net Margin Method (TNMM), we need to determine the net profit of a controlled transaction of an associated enterprise (tested party). This net profit is then compared to the net profit realized by comparable uncontrolled transactions of independent enterprises. As opposed to other transfer pricing methods, the TNMM requires transactions to be broadly similar to qualify as comparable. Broadly similar in this context means that the compared transactions don't have to be exactly like the controlled transaction. This increases the amount of situations where the TNMM can be used.

- Selection of the tested party- an entity for which net profitability of the controlled transactions is to be tested may not necessarily be the tax payer.
- Period of comparison- as per IT rules, multiple year data can also be used for comparability, in order to eliminate the accounting differences, product life cycles, varying businesses and discrepancies in short term economic conditions. The averages for the multiyear data can be simple or weighted average depending upon the facts of each case.

4. Selection of Method

The OECD generally prefers the traditional transaction methods as they are a more direct way of identifying a transfer price. However, ultimately the facts and circumstances of the transaction are important. In cases where no or not sufficient information on third parties is available or where business processes are very complex and a two-sided approach is needed, the transactional profit methods can be more appropriate. The process of identifying the most appropriate method differs between countries, but it often includes the testing of each single method.

In practice, the TNMM is the most used of all five transfer pricing methods, followed by the CUP method and Profit Split method. Cost Plus Method and Resale Margin Method are barely used.

5. Indian TP Documentation

The Indian TP Regulations were introduced in 2001, as a measure against tax avoidance. The Indian TP Regulations are largely influenced by the OECD TP Guidelines, but are modified to specifically suit the Indian tax regime. Applicability of transfer pricing provisions was earlier limited to International Transactions only in India. But, w.e.f. 01.04.2013, the scope of Transfer Pricing provisions is extended to specified domestic transactions and is accordingly applicable from A.Y. 2013-14. The Income Tax Act provides that every person/business enterprise entering into an international transaction or specified domestic transaction with its associated enterprise shall obtain a report from a Chartered Accountant in the prescribed form and furnish the same to the Income Tax Department. As per Section 92E, the assessee has to take an accountant's report, in Form 3CEB¹, duly signed and verified as per the provisions of the Act. Penalty for failure to furnish form 3CEB by the due date attracts a penalty of Rs. 100,000. The Transfer Pricing Audit Report is required to file electronically on or before the due date of filing of Income Tax Return i.e. on or before 30th November of the respective assessment year. Failure to maintain such document or failure to report or furnishing incorrect information can attract a penalty of up to 2% of the value of each transaction, where non compliance exists. Also, Tax authorities may, in the course of any proceeding, require any person who has entered into international transactions to

¹ Form 3CEB is a report from an accountant to be furnished under section 92E relating to international transactions and specified domestic transactions..

furnish any related information or document. The taxpayer must furnish such information or document within a period of 30 days from the date of receipt of a notice. Failure to furnish information can attract a penalty equal to 2% of the value of the specified transaction for each such failure. In case of a transfer pricing adjustment, in absence of good faith and due diligence by the taxpayer in applying the provisions and maintaining adequate documentation, penalty would be 100%-300% of tax on the adjusted amount.

Risks Associated with Transfer Pricing

- There can be a conflict among the organizational managers as what the policies should be regarding the transfer pricing. For e.g., whether 5% or 10% mark-up should be charged over cost for provision of services basis its nature.
- There are a lot of additional costs that are linked with the required time and manpower which is required to execute transfer pricing and help in designing the accounting system.
- It's difficult to estimate the right amount of pricing policy for intangibles such as services, as transfer pricing does not work well as these departments do not provide measurable benefits.
- The entire process of transfer pricing is highly complicated and time-consuming in large multinationals.
- Service Recipient and Service Provider perform different functions from each other and might undertake different types of risks. For instance, the seller may or may not provide the warranty for the product. But the price a buyer would pay would be affected by the difference. The risks that impact prices include Financial & currency risk, Collection risk, Market and entrepreneurial risk, Product obsolescence risk and Credit risk.

Transfer Pricing: A Global Hot Topic

Transfer pricing is very significant to corporate policy makers, economic policy makers, tax authorities, and regulatory authorities in any economy. Some of the reasons for increase in its scope are as follows:

- Transfer pricing affects the amounts paid as corporate tax. Transfer pricing is not an exact science, therefore it is easier for tax authorities to impose transfer pricing adjustment and recalculation of taxes to be paid from the budget. This is why companies which are part of a group must have strong arguments (through TP documentation) that intra-group transaction prices are at arm's length.
- The volume of international transactions crossing borders has grown exponentially over the last decade. Also, tax authorities are looking more and more to transfer pricing as a way to increase tax revenues.
- Transfer pricing can involve revenue or expense adjustments which might result in double taxation. Since transactions between two related parties are not subject to the same market forces as transactions between independents, over or under-pricing can affect the allocation of tax bases among the various jurisdictions in which the group operates. By shifting profits from one jurisdiction to another, distorted transfer pricing can expose multinational companies to double taxation if two jurisdictions involved in a cross-border transaction claim taxing rights on the same profit.

- Transfer pricing analysis involves a thorough understanding of how the group works, its key value drivers, and therefore can indicate ways of optimization.
- Transfer pricing affects cash flow, investment decisions and performance indicators from a multinational company point of view, transfer pricing can influence cash flows (e.g. additional corporate tax imposed by the tax authorities will reduce the resources at hand), investment decisions (e.g. a jurisdiction with frequent changes of the transfer pricing legislation will bring uncertainty for multinational companies that could favor the decision to exit a certain country) and key performance indicators (e.g. additional corporate tax imposed by the tax authorities reduces the profitability a company could offer to its shareholders).
- Transfer pricing is subject to legal requirements. More and more countries have now included transfer pricing in their local legislation imposing fines, penalties, additional tax or other forms of constraint for not complying with the regulations.

6. Transfer Pricing Case Laws

Transfer pricing affects the amounts paid as corporate tax. Transfer pricing is not an exact science, therefore it is much easier for tax authorities to impose transfer pricing adjustment and recalculation of taxes to be paid from the budget. There are number of cases (either completed or pending in court) in India and around the world which shows how tax authorities of different jurisdictions are demanding huge adjustments or recalculation of taxes from corporate having intergroup transactions. Therefore, it becomes essential for companies which are part of a group to have strong arguments (through TP documentation) that their intra-group transaction prices are at arm's length. Below is the summary of few cases which have been closed recently in 2017:

Amazon.com Inc

Amazon.com Inc won a US Tax Court case on March 23, 2017, fending off IRS² transfer pricing adjustments relating to a cost-sharing agreement (CSA) buy-in payment. The transfer pricing adjustments would have increased Amazon.com Inc's taxable income by more than \$1.5 billion in 2005 and 2006. Following case of Veritas Software Corp. v. Commissioner³, 133 T.C. 297, the Court concluded that the IRS committed a mistake when it used the discounted cash flow (DCF) method to recalculate a buy-in payment for Amazon's transfer, under the CSA, of preexisting intangibles to a Luxembourg subsidiary, Amazon Europe Holding Technologies SCS. The case concerns a 2005 CSA pursuant to which Amazon.com, Inc., and its domestic subsidiaries transferred to the Luxembourg subsidiary intangible assets required to operate Amazon's European website business. Under the agreement, Amazon US

² Internal Revenue Service is a U.S. government agency responsible for the collection of taxes and enforcement of tax laws

³ See <http://ww2.cfo.com/accounting-tax/2009/12/veritas-scores-a-major-transfer-pricing-victory/> for details on this case.

transferred three groups of intangible assets: software and other technology needed to operate Amazon's European websites, fulfillment centers, and related activities; marketing intangibles, such as trademarks, tradenames, and domain names; and customer lists and other information relating to Amazon's European customers. The Luxembourg subsidiary made buy-in payments to Amazon of \$254.5 million over seven years in exchange for the use of the intangibles. The subsidiary was also required to make annual cost sharing payments to compensate Amazon for ongoing intangible development costs. To determine the buy-in amount, Amazon valued each group of transferred assets separately using the comparable uncontrolled transaction (CUT) method. Amazon assumed that each group of assets had a seven-year useful life. The IRS determined that the buy-in payment was not arm's length, concluding it should be \$3.6 billion rather than \$254.5 million, but later reducing that amount to \$3.5 billion. The IRS applied a DCF methodology to the expected cash flows from the European business to arrive at its valuation. The IRS also disputed Amazon's ongoing cost sharing payments, increasing those required payments to \$23 million and \$109.9 million in 2005 and 2006, respectively. Due mostly to the recalculated payments, IRS determined deficiencies for 2005 and 2006 of \$8.4 million and \$225.7 million, respectively. The IRS also increased the amount of Amazon's net operating loss carryover deduction used by just over \$1 billion in 2005 and by \$304.8 million in 2006, according to Amazon's Tax Court petition. Siding with Amazon, the Tax Court rejected the IRS's recalculation of the buy-in payment, concluding it was arbitrary, capricious, and unreasonable. The CUT method, used by Amazon, was the best method to calculate the CSA buy-in payment, the Court said. The Court said that the DCF methodology used by the IRS was similar to the transfer pricing methodology used in the Veritas case, which has been rejected by the Court. Also, the IRS's DCF methodology improperly included in the buy-in payment the value of subsequently developed intangibles, as was the case in Veritas. With respect to the ongoing cost sharing payments under the CSA, the Court concluded that the IRS abused its discretion in determining that 100% of certain costs constitute intangible development costs (IDCs).

Honeywell Turbo Technologies (India) Pvt. Ltd (TS-84-ITAT-2017(PUN)-TP ITA No.2584/PUN/2012 dated 10.02.2017)-

Honeywell Turbo Technologies (India) Pvt. Ltd (The assessee) was engaged in the business of sale of Turbo charges and components by getting the same manufactured from its consignment manufacturers. The assessee also re-sells turbocharges and components imported from its associate enterprises and also provide after sales services to the customers. The Assessing Officer made a reference under section 92CA(1) of the Act to the Transfer Pricing Officer (in short 'the TPO') for computation of arm's length price of international transactions undertaken by the assessee. The TPO accordingly proposed upward adjustment of Rs.13,84,17,150. The assessee filed objections before the Dispute Resolution Panel (in short 'the DRP'), who vide its directions dated 05.09.2012, upheld the adjustment made by the TPO. The assessee has raised several grounds of appeal against the TP adjustment made. The first ground of appeal raised by the assessee is general against the TP adjustment.

The other grounds raised are specific on issues of TP adjustments. The adjustment has been made on account of each of the segment and we proceed to decide the issue by referring to the facts and circumstances of each segment separately. Below is the summary on nature of appeals and the final decisions made by the tribunal against each appeal. First segment (Manufacturing operations) - The first transaction pertaining to Manufacturing segment was held by the TPO to be not at arm's length. In respect of manufacturing segment, the plea of assessee was that no adjustment has to be made to the manufacturing segment as the difference between the revenue earned by the assessee and the arm's length price determined by the TPO does not exceed 5% and hence, it is covered under proviso to section 92C(2) of the Act. The benchmarking of international transactions have been carried out by the TPO in the case of assessee which in turn has been approved by the DRP and applied by the Assessing Officer while passing the order under section 143(3) r.w.s. 144C of the Act. Both the assessee and the TPO had applied TNMM method to benchmark the international transactions and PLI of assessee for the said segment by applying OP/OC was worked out at 3.66% (or 3.67%). The TPO had calculated the margins of comparables and the arithmetic mean of final list of comparables worked out to 8.54%. Proviso to section 92C(2) of the Act provides a benefit to the assessee that no transfer pricing adjustment would be made in case the arm's length price determined by the TPO was within range of +/- 5% of the actual revenue from the international transaction. The perusal of the order of TPO and the details filed by the assessee reflect that the margins of international transaction relating to manufacturing segment was were within +/- 5% of actual revenue earned from the manufacturing segment and hence, the Assessing Officer is being directed to verify the claim of assessee and ITA No.2584/PUN/2012 Honeywell Turbo (India) Pvt. Ltd to delete the addition.

Second Segment (Business Support Services or BSS Segment)- Now, coming to the second segment undertaken by the assessee i.e. Provision of business support services and supply based development services and information technologies, the assessee provided two kinds of services under the said segment; supply based development services and information technology and business support services to its associate enterprises. The learned Authorized Representative for the assessee had explained the nature of services provided by the assessee to its associate enterprises in BSS segment. The assessee had picked up 12 comparables on multiple year data basis and the average margins of comparables worked out to 9.36%. However, the TPO directed the assessee to re-work the margins on single year's data and after excluding few of the earlier selected comparables, the assessee re-worked the mean margins of comparables at 6.22%. However, the TPO applied margins of all the comparables initially picked up by the assessee and the average margins of comparables worked out to 47.33%. On perusal of record and various submissions made in respect of business support services, it transpires that the assessee had provided support services to its associate enterprises i.e. supply based development services, wherein the revenue earned was Rs.9,34,38,095. Further, the assessee had made provision of IT services to the extent of Rs.59,64,133 which constitute IT and other business support

services. The assessee in its TP study report had selected 12 companies as functionally comparable and on the basis of average margins of three years found the transactions entered into by the assessee with its associate enterprises at arm's length price. However, the TPO directed the Assessing Officer to apply only margins of current year in order to work out the margins of comparables. The assessee thus, re-computed the margins of comparables but in the process excluded certain concerns and applied the margins of few concerns and the average margins ITA No.2584/PUN/2012 Honeywell Turbo (India) Pvt. Ltd. worked out at 7.85%, which was found to be at arm's length of PLI declared by the assessee. The TPO however, applied the margins of the concerns originally picked up by the assessee as functionally comparable and updated the margins by applying single year's data. The arithmetic mean of final list of comparables worked out to 47.33%, against which the TPO proposed adjustment of Rs.3,63,87,000, against which the assessee is in appeal. Final decisions made by the tribunal are as follows:

- Rejected the plea of assessee for exclusion of ICRA Online Ltd. on the grounds of functionally non comparable and therefore uphold the inclusion of ICRA Online Ltd. in the final set of comparables
- Directed TPO to exclude TSR Darashaw Ltd. from the final set of comparables, the Tribunal also held that the change in profile of the company in comparison to the earlier two years makes it non-comparable and just because it had been selected by the assessee itself in its TP study, such company could not be made comparable.
- Supported functional analysis conducted by assessee for Saket Projects Ltd and ordered that it is not functionally comparable and hence, cannot be included in the final list of companies.
- Supported assessee's plea for exclusion of Access India Advisors Ltd. on the ground of fluctuating operating margins as the perusal of tabulated details filed by the assessee in its written submissions reflect that there is substantial increase in turnover in assessment year 2008-09 and then there is constant decline in the turnover in ITA No.2584/PUN/2012 Honeywell Turbo (India) Pvt. Ltd. the succeeding year.

Third Segment (Provision of Application Engineering Services)- The assessee has explained that the application engineering services was comprised of customization of business of turbocharges to particular vehicle models of different customers, where the best design of turbocharges is already developed and patented and the assessee provides services relating to customization of the best design as per the requirements of customer. In order to analyze the international transactions of AE segment, the assessee had ITA No.2584/PUN/2012 Honeywell Turbo (India) Pvt. Ltd. followed TNMM method and had selected concerns totaling 15. However, the TPO directed the assessee only to consider single year's data and the assessee re-computed the margins of comparables but excluded certain concerns. The TPO applied the margins of most of the concerns which were initially selected by the assessee as functionally comparable and held the same to be not at arm's length and made addition of Rs.66,72,350, against which the assessee is in appeal. During the appeal, the Tribunal held that the assessee engaged in providing application engineering

services was comparable to Ace Software Exports Ltd considering that the company was held to be functionally comparable to the assessee in the preceding year and that the Revenue had failed to show change in functionality in the present year and that its operating margins did not reflect it to be persistently loss making concern. Also, it dismissed the contention of the assessee for the exclusion of Vardan Projects Ltd on ground of higher margins of 96.33%, stating that assessee had failed to prove that there was any functional dissimilarity between the assessee and the said company or that the high profit margins did not reflect the normal business condition. The assessee had filed certain submissions in which reference was made to the inclusion / exclusion of some other concerns also, but no submissions have been made by the learned Authorized Representative for the assessee in this regard and hence, the same are rejected.

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