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ESSENCE OF TRANSFER PRICING – ISSUES, CHALLENGES AND A ROADMAP AHEAD

Dr. Hemant G. Abhyankar* **Dr. Sonali Prasad Dharmadhikari****

**Professor and Head of the Department (Economics), Bharati Vidyapeeth University Institute of Management & Entrepreneurship Development, Pune.*

***Associate Professor, Financial Management, Bharati Vidyapeeth University Institute of Management & Entrepreneurship Development, Pune.*

Abstract

The related enterprises are often guided by various considerations to fix price for transfer of goods and services among group entities at a higher or lower level than otherwise they would have agreed with unrelated entities which further results into profit distortion of the related enterprises which is understated or overstated in the hands of other enterprises. Against this background, as different countries have different tax rates and provisions, the transfer pricing is resorted to minimize tax liability of the group by profit maximization of associated enterprise in low tax jurisdiction. Such situation results into wide spread conflicts of interest among Govt and MNCs in determining tax share due to the Govt. In simple terms, the problem lies in the fact that Govt. wants to earn more tax and MNC wants flexibility to save tax and no country whether developing or developed would like its tax base to suffer.

Key Words: Profit Centre, Related Parties, ALP/Transfer Pricing, Conflicts in Taxation, Indeterminateness of ALP.

The dismantling of trade barriers, opening of economies, coupled with the technological advancement and IT explosion has led to corporate exploring avenues for expansion of business beyond borders of country.

Indian Multi National Corporations (MNCs) are no exception to above phenomenon and India too has witnessed substantial rise in the growth and volume of trade beyond the borders of country. Thus, MNCs in India are playing significant role in capital investment, employment and enhancement in GDP.
However, the flip side of the above is that these MNCs are often criticized for blatantly ignoring

a) Cultural norms.
b) Environmental issues.
c) Complex and complicated Taxation issues causing revenue loss to the exchequer.

Out of these, the research paper undertaken focuses on Intricacies of Arms Length Pricing and disputes in computation of A.L.P., Taxation issue and related revenue aspects that cause serious concern to Tax administration and authorities of Government. This Taxation issue of MNCs arising out of their cross border trade transactions is one of the significant and at the same time controversial topic in International Taxation and same is referred to as “Transfer Pricing”.

As the title indicates, the Research paperinitially identifies and state clearly “Issues” followed by the“Challenges” posed based on illustrations drawn from the “experience survey” and “insight stimulating cases”which provides basis for Primary data. The Secondary data is drawn from Survey Report and OECD Guidelines obtained from the literature available.

In concluding part of the research paper, the “Primary as well as Secondary data” so obtained is analyzed to suggest a Roadmap Ahead.
Thus, organization of the research paper is as under:

i) Issues related to Transfer Pricing (ALP)
ii) Challenges and controversies in ALP determination
iii) A Roadmap ahead towards dispute resolution

Before discussing issues related to TP, it is necessary to understand the very concept of Transfer Pricing from the viewpoint of Economics and Taxation.

Economic and Taxation Perspective of Transfer Pricing
Economic meaning of Transfer Pricing is with reference to external and without external market.

Today’s MNCs are vertically integrated i.e. they contain several divisions. With some divisions produce parts/ components (upstream division/ subsidiary company) that other division (downstream division/ parent company) uses to produce finished goods. Transfer price is an internal price at which parts and components of upstream division are sold to downstream division or from Subsidiary to Parent company.

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The optimal transfer price within divisions that don't trade across (without external market) is argued to be price equal to marginal cost. However, when it comes to products being transferred internationally (With external market) then tax laws and regulations differ resulting into disputes regarding the transfer price fixed/ set. Thus, the Transfer pricing issue becomes complex in international business where transferred product is sold across the border by MNCs however, there is a tendency of manipulating transfer prices so that profits move out of division located in higher tax regions to lower tax regions. Such practices have direct bearing on exchequer's revenue. Ideally, market price based transfer price ALP will only induce goal congruence.

Transfer pricing under the concept of taxation refers to determination of ALP of transfer of goods/ services / use of property between the associated enterprises. Under the roots of taxation, ALP is required to be justified with analysis, documentation and adjustments made on the basis of functions, assets and risk analysis. The statutory basis of the taxation aspect of Transfer Pricing goes to OECD and UN manual related to TP guidelines.

As regards India, TP regulations were introduced in the year 2001. The most important part under Indian TP mechanism is that the primary onus is on the taxpayer to determine ALP according to regulations and substantiates same with prescribed documentation.

The concept of ALP is evolved from economic and taxation meaning of TP. Under this principle, controlled (Intra group transactions) are compared to uncontrolled (transactions between unrelated parties) and price of the similar transaction is a major/ benchmark to verify price fixed for intra group transaction and their acceptability for taxation purpose.

Issues Related to TP

Against the backdrop of meaning of transfer pricing from the viewpoint of taxation and Economics, the researcher has taken up some cases to stimulate and gain more insight into issues related to TP.

Thus, in further part the researcher has presented few cases and analyzed these cases to draw certain observations and inferences and thus arrived at specific conclusions thereby bringing to fore issues related to TP.

Illustration I

Suppose, a TV manufacturing group in Country 'A' buys picture tubes from its subsidiary in Country 'B'. The price that Parent company in Country 'A' pays to its subsidiary company in Country 'B' (Transfer Price) will determine how much profit Country 'B' unit report and how much tax it pays. If Parent company pays lower than ALP then, Country 'B' unit will be in financial difficulty even though group as a whole shows a different profit.

From Tax authorities perspective, Country 'A' Tax authority might agree with profit reported by TV manufacturing group in Country 'A' but, Country 'B' counterparts disagree.

Had Country 'A' bought its component from independent company in Country 'B' it would have been required to pay market price and the supplier would result into better profits.

The above issue gains significance when tax rate in Country 'A'is lower and that in Country 'B' is higher.

The implication of above illustration from taxation point of view is as parent company bought the TV tubes at a lower price than ALP it resulted into low costs high profits and if it is presumed that tax rate is lower in parent company then, setting incorrect transfer price led revenue loss to the exchequer.

Hence, the setting of ALP is crucial but at the same time debatable leading to dispute.
The analysis of the above illustration led researcher to draw following observations:

1. There is a tendency of manipulating TP and profits and Taxes. Such practices have a direct bearing on exchequer's revenue.
2. It is therefore necessary to discourage use of TP for changing the location of profit.
3. In the country with a low tax regime goods are sold at low price and therefore cost been low and though profits are higher tax liability is less resulting revenue loss to the exchequer.
4. The country having high tax regime goods are purchased at high price, therefore cost being high and profit being low so tax liability is also low resulting loss to the exchequer.
   In either case, the issue under consideration is whether the price charged is ALP or otherwise.

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Illustration II

The following hypothetical illustration will explain how transfer pricing is used as a device to evade tax burden.

Suppose, the firm in USA has its subsidiary in economy where tax rate is 20% whereas in USA, tax rate is 40%. In this case, firm in USA will benefit in terms of total profit after tax by setting higher transfer price for goods/ inputs/ raw material transferred from subsidiary to US parent company.

Table: I

	Foreign Subsidiary	**US Parent Company**
Total Revenue	2,000	3,800
Cost of goods	1,200	2,000
Other Costs	300	400
Earnings before Tax	500	**1,400**
Taxes (20% to 40%)	100	560
Income after Tax	400	840
Income after Tax of Subsidiary and Parent company together is 1,240.		

Now, if Transfer price is increased, **Table: II**

	Foreign Subsidiary	**US Parent Company**
Total Revenue	3,000	3,800
Cost of goods	1,200	3,000
Other Costs	300	400
Earnings before Tax	**1,500**	400
Taxes (20% to 40%)	300	160
Income after Tax	**1,200**	240
Income after Tax of Subsidiary and Parent company together is 1,440.		

The analysis of the above illustration led researcher to draw following observations:

1. In table, total revenue of subsidiary from selling to parent company appears as cost of goods shift from subsidiary to US parent on Income Statement of Parent company as the amount paid for transferred goods is cost to the parent company, the higher transfer price policy reduces before tax income of the company, but increases it for subsidiary company. The total after tax income of two units is 200units higher with high transfer price.

   Thus, total tax in Table I comes to 660, and after setting higher Transfer Price total tax burden becomes 460 i.e. reduced by 200 whereas, Total profit in Table I is 1,240 and has become 1,440 after setting higher Transfer price. Thus, loss to the exchequer is of 200 units.

   Thus, it is observed that MNCs use Transfer pricing to dress up Financial Statements.
2. The firm can benefit in terms of Income after tax by setting higher transfer price for goods shift from subsidiary (20%) to US Parent Company (40%).

The issue under consideration is setting of the correct price when goods are transferred between two units of the company. In order to set the correct price the method adopted is Arm's Length Price which itself is a Transfer Price.

Illustration III

A watch manufacturer in Country A distributes its watches through a subsidiary in Country B. Manufacturing Unit's cost of watches is Rs. 2,400 and in Country B distribution cost is Rs. 200. Country A sets Transfer Price Rs. 2,500 and subsidiary in B retails watch at Rs. 2,700.

Overall A & B together makes a profit of Rs. 100 on which taxes are being paid in country A. When Tax authorities in Country B carry out audit, they noticed that distributor has not earned any profit.

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Since, Transfer Price of watch 2,500 + Distribution Cost 200 = Retail Price 2,700.
Therefore, Country B tax administrator considers that TP should be set at 2,400 so that B's unit shows the group Rs. 100 as profit and would be liable for tax.

Actually, Parent company has already paid tax of Rs. 100 per watch. However, as a multinational group it is liable for tax when it operates in a group i.e. country A & B. Thus, it results into double taxation.

The analysis of the above illustration led researcher to draw following observation:
At times it so happens that setting of the price for particular product of the manufacturing unit and its Distributing and Marketing Division creates the problem of double taxation.

Inferences
The observations drawn on the basis of analysis of above three illustrations led researcher to draw following inferences in general:

1. In the process of manufacturing, a product moves from different stages from raw material to intermediate product to a finished product and finally to salable product. In these stages it goes from one unit to another unit of organization. In such cases when product moves from one unit to another unit, the pricing policy should be market based/ negotiated or cost based.
2. The organization in the process identifies profit centre and if each intermediate profit centre is given free hand to set its own price, then price of final product may result into exorbitant price because price charged by the previous unit is the cost price of subsequent unit. This chain reaction then it will result into price which will not give expected profit to the organization and moreover loss to the exchequer.
3. From economic point of view, the TP of an organization should be such that it will not affect the corporate goal of profit maximization.
4. From the taxation point of view, TP here refers to the determination of ALP of transfer of goods or services between associated enterprises.
5. Two enterprises are considered related if one of the enterprises participates directly or indirectly in the management / control or capital of the other.
6. When two strangers are involved in the sale of any tangible goods, it is obvious that agreed price will be close to market value because seller wants highest possible price while buyer wants lowest possible price. Whereas when two parties are not strangers/ related, it is unlikely that the price will be closed to the market value and there is every possibility that such transactions may not be always at ALP. Therefore, it is inferred that ALP is further required to be justified with analysis/ documentation and adjustments made.

From all inferences stated above, it is concluded that the issue/ problem relates to the fact that TP of organization should be such that would not affect corporate goal of Profit maximization and at the same time, would also not incur revenue loss to the exchequer or erode the tax base **and therefore issue under consideration is indeterminateness nature of Arms Length Pricing.**

Challenges and Controversies in ALP Determination
In further part of the research, the issue of indeterminateness nature of Arms Length Pricing elaborated and discussed above is probed further with reference to methods of ALP and statutes/ guidelines framed by OECD and UN organizations throws open controversies and challenges faced in ALP in determination of ALP. The nature of controversies stem from indeterminateness of ALP resulting into disputes between corporate and Tax authorities which is precisely the problem addressed in this research paper where attempt is made to find out whether there is any internationally accepted mechanism for setting transfer price and which in turn determine fair profit and tax and further reduce the disputes and redress controversies.

The research problem stated above becomes more complicated in a country like India where under TP mechanism the onus is on the tax payer to determine ALP in lying with the regulations and further substantiates with documentation.
In order to state the controversies and challenges, the researcher thought it fit to investigate further into the problem of indeterminateness of ALP against the backdrop of literature review on:

a) ALP Determination Methods

CUP	Under the CUP method, the price charged for the relevant transaction in a comparable uncontrolled transaction is determined. Such price is then compared with the price charged between the	Can be applied uniformly to any transaction if adequate data is available

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	similar transaction between AEs.	
RPM	Under the RPM, the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold to an unrelated enterprise, is identified.	Can be applied only in the case of Resale of product without any value addition.
CPM	The cost of production incurred by an enterprise in respect of property transferred to an associated enterprise is determined and the amount of a normal gross profit mark-up to such cost by an unrelated enterprise, in a comparable uncontrolled transaction, is determined	Can be applied only in the case of Manufacturing of Product.
TNMM	The net profit margin realized by an enterprise with related parties and the enterprise with its transaction from unrelated parties is identified.	This is the most commonly used method in India
PSM	Here Profit of the entire group is identified and split to its AEs according to their contribution in the entire product	The PSM is employed mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction

b) Statutory Basis of TP& Survey Reports

As per the survey conducted worldwide on the issue of Transfer pricing, Ten most aggressive tax authorities in the world are

Country	Rank in 2010	Rank in 2007
Japan	1	1
India	2	6
China	3	8
Canada	4	9
US	5	3
France	6	5
Germany	7	2
Australia	8	4
Korea	9	7
UK	10	10

(a) Transfer Pricing Under Indian Scenario

As far as Indian Transfer pricing regulations are concerned, it was introduced in 2001. The law is at evolving stage. The statistical data as available in public domain about the number of cases scrutinized and number of cases where adjustments has been made is as under:

FY	Number of TP Cases Completed	No. of Adjusted Cases	% of Adjusted Cases
2004-05	1061	239	23
2005-06	1501	337	22
2006-07	1768	471	27
2007-08	219	84	39
2008-09	1726	670	39
2009-10	1830	813	44
2010-11	2301	1138	49
2011-12	2638	1343	52

As per the available data in public domain about 3500 cases are pending before various appellate authorities.
The Statistics about Indian TP scrutiny is presented below

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1. Over 10,000 cases referred to the transfer pricing officers in last 9 years.
2. Almost 40% have faced an adjustment.
3. As per newspaper reports, FY11-12 and FY12-13 have seen adjustments totalling to over INR1.0 trillion (approx. US$16.7 billion).

Indian Transfer pricing regime started with the good intention of keeping a check on profit shifting but has become a revenue generating centre. The TP law in India is too subjective and not supported by a robust law. There are various attributes of TP disputes as far as India is concerned.
PWC Survey in 2015 reveals following data:

1. All participants believe India to be significant from the group's global TP
2. 85% of the respondents assigning importance to the maintenance of TP documentation.
3. 70% of the respondents strongly agree that they always litigate transfer pricing adjustments in appellate forums..

A survey was conducted by E&Y in 2013 indicates following concerns:
Survey by E & Y

1. India is considered as the most important jurisdictions for transfer pricing issues.
2. Tax risk management was most often identified as being of the highest priority when devising transfer pricing strategy.

Transfer pricing of intra group financial arrangements (loans, guarantees, etc.) has been the most important area of tax
A Global Transfer Pricing survey was conducted in 2010 by Ernst & Young across the world. Key results of survey are as under:

Finding	**America**		**APAC**				**EMEIA**		
	Brazil	**Canada**	**USA**	**Australia**	**China**	**Japan**	**Germany**	**India**	**UK**
TP is the most important tax issue for the group	28%	12%	19%	36%	30%	38%	36%	35%	24%
TP documentation is more important than it was two years ago	56%	64%	69%	40%	70%	83%	84%	95%	67%
TP Policy has been examined by a tax authority in any country since 2006	36%	72%	90%	68%	20%	53%	88%	45%	82%
Services transactions have undergone a review	56%	98%	54%	76%	0%	63%	73%	89%	85%
Intra-group financing transactions have undergone a review	33%	44%	19%	53%	100%	0%	55%	89%	43%
Tax risk management is the highest priority driving TP strategy	40%	28%	54%	68%	60%	73%	40%	45%	51%
Use of Pan-regional comparable sets across multiple jurisdictions	20%	24%	20%	32%	29%	9%	20%	15%	27%

Above survey clearly spells that in India, TP documentation is the area of concern. For a taxpayer, there is a need to give due attention to the documentation to be able to demonstrate a well structured transaction. This will produce greater results in terms of saving time and resources at the time of scrutiny of case before the tax authorities.

Even though literature is available on transfer pricing disputes in India, none of the literature has touched upon the issue to suggest the specific documents requirements for transfer pricing.

The analysis of the above data on methods and statutory framework and the survey led researcher to draw following observations pertaining to TP mechanism:

1. In spite of internationally set guidelines prescribed by Organization for economic cooperation and development along with detailed TP regulations in India prescribed through Section 92 to 92F of Indian Income Tax Act 2001 (which also includes detailed documentation) the controversies in TP assessment are continuously on rise. The table shows that during 2003 to 12, amongst the scrutinized cases, percentage of adjusted cases substantially increased from 23% to 52%. This in spite of the fact that IT Provisions derives its base from OECD guidelines only.
2. There are five methods used for determination of ALP, which are adopted across sectors like Pharma, Automobile, software for various products and services. Irrespective of the method used and sector selected still it results into disputes that can be attributed to some ambiguity in TP regulations because pricing of transaction is always difficult and based on functions/ assets/ risks associated. In addition, factors like efficiency of a division, location of division, group policies play important role. Due to all this, most importantly available methods like cup/ CPM/ TNMM/ PSM are without hierarchy of methods, thereby making TP calculations more subjective.
3. No country with developed, developing or under developed economies would not like its tax base to suffer due to artificial fixing of pricing of transaction between associated enterprises. Therefore, actually Tax Administrators started regulating their policies by adopting TP regimes to avoid erosion of Tax base and started scrutinizing transactions and determining prices by the principle of ALP. In case of Indian TP original intention was keeping track on profit shifting but now has become revenue generating aspect.
4. TP laws in India are too subjective in nature and India figures significantly in groups global TP and 70 % cases under litigation to Appellate forums.
5. Working papers on Law and Economics discusses about origin and evolution of TP mechanism without solutions.

On the basis of observations made above, it is inferred that available methods statutes, guidelines and secondary data, survey report etc. brought to light following interesting facts regarding challenges and controversies in TP mechanism:

1. The methods available lack hierarchy and invite controversies in selection of method itself.
2. The survey reports indicate various parameters that make computation of TP more complicated and there is no single parameter as such to determine TP.
3. In India where under TP mechanism the onus is on tax payer to determine ALP in line with regulations inviting disagreement between tax authorities and corporate.

Thus, to conclude,

1. The computation of ALP is always subjective and leads to disputes in spite of international and national guidelines.
2. The methods are not only without specifying hierarchy but emphasizes more on computation than elimination and amicable resolution of disputes.
3. Indian TP provisions have basis of OECD guidelines, however litigations between MNCs and Indian Tax Authorities are on rise.

To sum up, the issue related to ALP is highly subjective in nature and therefore has resulted into progressive rise in disputes and lacks transparency. Therefore, challenge is necessity of evolving dispute **redressing mechanism as a road ahead with an aim to** transparency in the process of arriving at ALP in such a way that will result into a kind of win- win situation for corporates and taxation authorities.

Roadmap

Towards fulfillment of the above aim, following facts be taken into account with a thrust on documentation while developing and designing a Roadmap:

1. To explore the possibility of arriving at uniform set of rules, for fixing TP in respect of Cross border trade transactions. (The researcher has observed the TP though based on OECD guidelines, when it comes to application, hindrance is that regulatory framework of Tax differs between two countries resulting into controversy/ debate and dispute.
2. At present, different methods have been used for arriving at ALP. These methods lack hierarchy. Therefore, it is felt that methods should be ranked and the hierarchy be assigned so as to avoid conflicts in ALP determination.
3. The whole issue of TP revolves around different Tax rates and there is a tendency to sell goods at higher price in a country where Tax rate is relatively high. Therefore, it is felt to explore the possibility of fixing mark up to arrive at the price and such mark up price could be ALP.
4. The proposed Road map should think of provision of section to consider Overall profitability of group companies so that cases of litigations will be reduced.

In addition to above, while demonstrating Transfer Pricing Policy of the organization before Income Tax, DOCUMENTS have a decisive role to play in arriving at Arms Length Price. Hence it is felt that ROAD MAP ahead should really focus on robust documentation.

In this context, towards robust documentation following possibilities could also be explored:

a) In view of the fact that trade contracts are of big amount and that too in foreign Currency and it's high time now to enhance the existing limit of Rupee one crore for maintenance of documents.
b) Since the nature of trade transactions vary, it is very difficult to prescribe standard set of documents irrespective of trade transactions. Moreover synchronization of documents of custom and tax authorities is not feasible as objectives differ in case of both.
c) To overcome the difficulty in determining ALP of intangibles it is necessary to devise some document so as to reflect receipt of tangible benefits from such payments.
d) If trade contract is for long term then documentation be asked only if there is change in terms and conditions of the agreement or change in the profile of the group or business.

Apart from this the Road Map should also explore the possibility of introducing the BRIGHT LINE CONCEPT in India (prevalent in Western countries) so as to have good impact on Revenue Collection.
Thus, to conclude, it is felt that the "Roadmap drawn on above lines would redress issues/ challenges & controversies over the transfer pricing.

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