COMPLEXITY OF TRANSFER PRICING DISPUTES AND THEIR PREVENTION MECHANISMS: USA AND INDIA

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ABSTRACT

The OECD MAP (Mutual Agreement Procedure) statistics for India and USA establish that transfer pricing disputes cover most of the MAP cases initiated under the US-India DTAA.[i] This paper attempts to analyse the complexity behind such disputes; point out the lack of simplicity, coordination and certainty in the transfer pricing legal framework of USA and India; highlight the need for a deeper analyses of the methodologies used for the computation of arm's length price, and the applicability of the same in transactions related to AMP expenses and Market Intangibles. Dispute preventions mechanisms such as APAs and Safe Harbour rules have also been briefly scrutinised to emphasize the effectiveness and the scope of improvement of such initiatives in reducing transfer pricing tax disputes between India and US.

INTRODUCTION TO TRANSFER PRICING

Transfer pricing (TP) deals with the price that a related enterprise charges its other counterparts for the goods and services it provides to them. Many subsidiaries of multinational enterprises use TP as a mechanism to reduce their tax burden by shifting their profits from high-tax jurisdiction to low-tax jurisdiction. If a subsidiary in a high-tax jurisdiction charges a subsidiary in a low-tax jurisdiction with prices below the 'true' price of its goods and services, the profit shifts from a high-tax jurisdiction to a low-tax jurisdiction. Such tax evasion practices became very common with the growth of world trade[ii]and thereafter, emerged the legal framework of TP policy.

LEGAL FRAMEWORK OF TRANSFER PRICING IN US AND INDIA

The domestic as well as international transfer pricing policy framework has been evolving in accordance with the OECD model to tackle with TP issues. Related parties are now allowed to transact at an 'Arm's Length Price (ALP)' which is determined by several methods prescribed in the domestic legislations of each country. Section 92 of the Income Tax Act 1961 in India and section 482 of the Internal Revenue Code (IRC) in the USA regulate TP in these respective jurisdictions.

The Double Tax Avoidance Agreement[iii] (DTAA) between India and US, like the OECD model, also deals with 'associated enterprise transactions' under Article 9 and further allows the reference of such disputes for Mutual Agreement Procedure (MAP) under Article 27. It permits tax authorities to restate the accounts of the enterprise if it does not reflect true profits accruing from transactions with associated enterprises. MAP Statistics[iv] show that India and US have the highest number of MAP disputes with each other. Moreover, most of these MAP disputes are transfer pricing disputes pertaining to either the attribution of profits to a permanent establishment (Article 7) or the determination of profits between associated enterprises (Article 9). Both, India and US have implemented several dispute prevention mechanisms like Safe Harbor Rules (SHR) and Advance Pricing Arrangements (APA) to control the creation of TP disputes in the first place. These initiatives were a consequence of the failure of USA and India's own domestic dispute resolution and litigation procedure for TP cases.

SOME COMPLEXITIES INVOLVED IN DETERMINING ALP

Comparables

Most legislations allow the same five methods for the computation of ALP. US with its 'best method'[v] approach and India with its 'most appropriate method'[vi]approach also allow other methods apart from these five methods to be used for determining the ALP in a transaction. This causes more uncertainty for the taxpayers and thus increases the possibility of more TP disputes. Furthermore, all these methods use comparable to ascertain the ALP for a transaction. However, there are no practical and definite guidelines or framework to carry out this comparability analysis for computation of ALP. [vii] Further, there are many transactions for which no similar or identical comparables are available and thereby comparability yields inaccurate results. Thus the tax authorities of the two nations should uniformly agree on allowing adjustments to the inexact results in order to get a more appropriate ALP.[viii] India permits comparability adjustments, whereas, US mandates it for the tax payers.[ix] Though the methods for computation of ALP follow a reasonable logic, the uncertainties that lie in arriving at an ALP due to the unique nature of most transactions still need to be dealt with to have a more pragmatic approach for computation of ALP.[x]

AMP (Advertisement, Marketing and Sales Promotion) Expenses and Market Intangibles

AMP expenses refer to promotion expenses incurred by an enterprise in promoting and advertising the brand, trademark and other intellectual property owned by its associated enterprise for which it is entitled to remuneration with a profit top-up. Such intangible property has been defined as "market related intangibles" in section 92B of the Finance Act, 2012 and is commonly referred to as "market tangibles". The main debate around AMP and market tangibles is concerned with whether this transaction should be treated as an 'international transaction' and hence be tested for ALP or not.[xi]

A contemporary example in which a similar concern was raised is that of LG Electronics[xii]. In this case, LGI (Indian Subsidiary of LGK) had received the contribution from LGK (parent

company based in Korea) regarding the expenses incurred by LGI for sponsoring the Global Cricket Events. Transfer Pricing Officer (TPO) observed that AMP expenses stood at 3.85% of its sales by LGI which was much more compared to the mean percentage of the amount spent by the similar companies being 1.39%. The TPO essentially relied on the 'bright line test' to ascertain the existence of an 'international transaction.' [xiii] However, this bright line test was overruled in the Sony Ericson Case[xiv] and the same was upheld in the Maruti Suzuki case[xv] in 2016. The court in these cases held that the bright line test is not a statutorily backed test and cannot be exhaustively used to determine the existence of an international transaction which is the first step in determination of transfer price. However, there has not been much legislative or judicial discussion on whether transactions involving APM expenses and market intangibles are indeed international transactions or not. Though the courts are progressing in the right direction, there is still a need of legislative provisions tackling with the scope of international transactions and the computation of ALP in case of APM expenses related transactions. Lastly, India does not have any specific guidelines on pricing of controlled transactions involving intangible property whereas US incorporates the same in Treas. Reg. 1.482-4.

ANALYSIS OF DISPUTE PREVENTION MECHANISMS IN TRANSER PRICING

APA

In USA, APAs can be concluded under the Advance Pricing and Mutual Agreement Program (APMA) for five years along with a rollback option. This implies that taxpayers can apply the benefit of negotiations under an APA for four years preceding the term of APA. In India, the Finance Act of 2012 allowed the CBDT to enter into APAs with the Indian taxpayers for predetermination of ALP for five years and in 2014 the CBDT introduced 'rollback' option for four preceding years in APA.[xvi] Additionally, CBDT also removed the necessity of a correlative adjustment clause in the DTAA of negotiating country for a bilateral/multilateral APA.[xvii] This means that even if a DTAA has no mention of APAs a taxpayer can still conclude a unilateral, bilateral or a multilateral APA with tax authorities of other jurisdictions.

Though the number of concluded APAs has been rising, there has been a slow down due to the increase in time limit for conclusion of an APA from twenty-nine to thirty-two months in the year 2016.[xviii] In addition, Unilateral APAs sometimes results in blocking access to MAP in case a double taxation issue arises at a later date[xix]. However, this does not solve double taxation issues but merely blocks all recourses of tackling with them. Unfortunately, the number of bilateral APAs signed by CBDT is significantly lower than the number of unilateral APAs, even though TP adjustments have bilateral implications[xx]. Nevertheless, APAs have been a successful attempt in reducing the number of dispute resolution cases in the sphere of transfer pricing. Yet, it can be used more effectively.

Safe Harbor Rules (SHR)

Safe Harbor Rules attempt to relieve a taxpayer from some usual obligations of transfer pricing and the uncertainties that lie in this regime, provided that certain conditions are met. Compliance with the safe harbor rules leads to automatic approval of transfer prices by tax authorities. This results in certainty, simplicity and cost effectiveness in performing international transactions. Section 92C of the Income Tax Act also defines 'safe harbor'.

Unilateral Safe Harbor Compliance can lead to divergence from arm's length principle and therefore result in either double taxation or double non-taxation. As these are predetermined rules, enterprises may exploit them by entering into artificial arrangements to attain tax planning benefits.[xxi] SHRs are usually limited to small and medium service providers and limited sectors like IT, ITeS, KP, R&D etc. However, the complexity and indeterminacy of transactions in these sectors further increases ambiguity in the application of SHR.[xxii]

Regardless of these difficulties, safe harbor is a significant attempt to tackle the uprising disputes and litigation in TP. The best solution for the raised concerns is bilateral safe harbors which will ensure mutual coordination and agreement between both the tax authorities involved. The authorities should uniformly agree upon the ALP computation to avoid double taxation, tax planning or double non-taxation and make these rule most effective.

SUMMARY OF KEY CONCERNS

It is now evident that international TP Disputes often involve conflicting interests of three parties: - the taxpayer who wants a low tax burden, authorities of the high-tax jurisdiction and authorities of the low-tax jurisdiction. Thus, domestically incorporated mechanisms can only be effective if there is mutual agreement between all parties on the determination of arm's length price and permanent establishment of associated enterprises. The ambiguity in the scope of international transactions for AMP related transactions and determination of ALP, particularly in the use of comparables needs urgent attention to attain simplicity, certainty and uniformity for all taxpayers.

Though the number of Unilateral APAs in each nation is way more than the number of Bilateral APAs[xxiii], it is worthy to note that the APAs concluded between India and US have been increasing.[xxiv] Further, India recently revised its safe harbor rules in 2017[xxv] for taxpayers so as to avoid transfer pricing disputes and audits from arising. India has also started a three-layered documentation process in accordance with Organization for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Action 13 on transfer pricing documentation and CbC reporting. Furthermore, India and US have also entered into an agreement on the exchange of country-by-country reports with respect to MNE Groups.[xxvi] This confirms that the tax authorities of both jurisdictions understand the need and potential of dispute prevention mechanisms in dealing with the increasing number of tax disputes between the countries. However, a deeper analysis of enhancing the role of these mechanisms to get more effective results is a crucial requirement in the present scenario. The procedure and increasing time limit to conclude APAs[xxvii]; the complexity and inconsistencies involved in opting for APAs[xxviii] and safe harbor rules in different jurisdictions; the limited scope of the applicability of safe harbor rules; the disadvantages of one-sided agreements with a single tax-authority like unilateral APAs or SHRs are other important considerations to be kept in mind in confronting the tax disputes between India and US.

CONCLUSION

In the current era of digital economy, the difficulty and indeterminacy in locating the source of income or the permanent establishment of a corporation has increased. Hence, there lies an urgent need of enhancing the efficacy and simplicity of the transfer pricing legal framework and dispute prevention mechanisms along with coordination between tax authorities of different countries with respect to the same. The tax authorities of India and USA should negotiate on the discussed issues and bring about the agreed changes in their DTAA or enter into subsequent agreements to minimize the tax disputes between them.

ENDNOTES

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