Transfer Pricing in India – A Distant Concept??

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Abstract
This paper gives a basic idea about what is transfer pricing and also highlights the essentials which go in drafting of these policies. The importance of foreign direct investment and the role of MNE is also checked. The tax implications and other reasons of these policies are also covered. The coverage of transfer pricing in developing countries and its impact is looked into. The question which arises in mind is that ‘Is this concept already here or still it is a far fetched distant dream which is yet to take roots in India’?

Keywords: Transfer Pricing, Tax implications, Role of MNE, Developing Countries.

Introduction
‘What is Transfer pricing’?
Like any transaction between independent enterprises, management of a firm in a Multinational Enterprise (MNE) system has to fix a price for an intra-firm transaction. This price is known as ‘transfer price’. It is defined as ‘the price set by related corporations for the sale or other transfer of goods. Services and/or intangible property thereof’ (UNCTAD 1997). The OECD defines ‘transfer price’ as ‘prices at which an enterprise transfer physical goods and intangible property or provides service to associated enterprise’ (article 9 of the OECD model tax convention). Consequently the term ‘transfer pricing’ refers to the process of attaching value of transfer of goods, services and technology between related entities.

Thus, transfer prices are essentially set within a single enterprise as against market prices set in transaction between independent enterprises, where only market is the guiding factor. Apart from this, the associated enterprises in an MNE system are guided by the ‘group’s objectives’, which may differ from the objectives of the associated enterprises. This makes transfer pricing a complex exercise, different from price determination by an enterprise in its transaction with another independent enterprise under uncontrolled conditions.

Owing to complexities involved in intra-firm transactions, tax authorities often find examination of transfer prices a difficult exercise. In many cases, depending upon the method of transfer pricing, different values of transfer prices can be arrived at. In such situations instead of one price, a range of transfer prices has to be identified.

Apart from the reason stated above, factors responsible for making transfer pricing a dominant issue in international taxation include:

- The on-going (re)location of production of final products and of components to appropriate territories for taking advantage of reduced production costs, better infrastructure, skilled labor forces, greater tax incentives, etc.;
- Concentration of service functions within MNEs;
- The emergence of e-commerce, where by time and geographical barriers have lost significance;
- The widely held impression especially on the part of tax administration that transfer pricing is used for shifting profits out of their jurisdictions;
- Realization by MNEs that getting transfer prices wrong would lead to double taxation.
Factors influencing Transfer Pricing

As mentioned, transfer prices, per se, are amount charged by one associate of an MNE for goods or services that it supplies to another associates of the same MNE. In this sense, transfer pricing enables managers to decide whether to buy or sell goods and services inside or outside the group. Consequently, transfer pricing becomes a tool that managers can use to evaluate performance of various associates of the MNE. If management of the group wants its branches and subsidiaries in different countries to operate as independent profit centres, then it may set these prices as close as possible to market transaction between unrelated purchase and sellers (hamaekers 1996; McCarten 1995; hamid, 1995; stern 1994). In such situation, managers of the associates would be free to negotiate prices as two independent enterprises would do for finalizing a transaction. Thus, transfer prices should be seen as no more than administrative prices set by management of an MNE. According to this view open market prices are charged internally because the firm evaluates each foreign associate on the basis of its individual profits performance, that is, as separate profits centre. It is further argued that another possible reason why the firm might not adapt discretionary transfer prices is the enforcement of arms length pricing guidelines by tax and customs authorities in home and host countries (Ernst & Young 1997). Thus, it is claimed that transfer pricing is tax neutral in nature and that an MNE and its associates usually act as a group of unrelated parties by setting arms-length prices in intra-firm transaction.

However, the matter is not always as simple or straightforward as that. There are several factors, which are known to influence the seemingly internal and therefore innocuous matter of transfer prices. A comprehensive study to identify the relative importance of various factors responsible for transfer pricing was undertaken by Arpan, who conducted a study of non-US transfer pricing system (Tang, 1981). The subject of his questionnaire survey were the wholly owned U.S. subsidiaries of foreign firms. One of the important findings of his study was that all large MNEs consider essentially the same external variables when they formulate their guidelines for transfer prices. The study highlight that income tax has been considered as the most important factor by most of the respondents. There are, however, distinguishable national differences in the number of variables considered and their relative importance.

Lall & Streeten (1977) summarized the factors influencing transfer pricing into two groups:

a) Those that arise from the desire to increase global post-tax profits such as: international differences in tax and tariff rates, multiple exchange rates, quantitative restriction on profit remission, existence of local shareholders, exchange-rate instability, and the overstating of apparent costs as a mean to obtain higher protection against imports.

b) Those that arise from the need to reduce risk and uncertainty over the long term, such as present and anticipated balance-of-payment difficulties, political threats to profit repatriation (or to survival) in a particular country, trade union pressures, and the risk of attracting competition from other (mainly multinational) firms.

Thus, MNEs have fiscal as well as non-fiscal incentives to engage in discretionary transfer pricing practices (Kopits, 1976). Though no study has been undertaken to estimate the exact influence of each factor on transfer pricing, studies show that the variations of transfer prices from market prices are substantial. Vaitos (1977) observes this variation in Columbian pharmaceutical, rubber and electronic industries. She refers also, to lall’s observation of particularly high incidence of overpricing ranging from 33 percent to more than 300percent of the international market prices. This massive manipulation arises because MNEs can control transfer prices; they may fix these at levels different from the prices which would be obtained in arm’s length transactions with a view to shifting profits artificially from one area of operation to another.
Findings of certain studies focused on transfer pricing abuses in individual countries or within specific industries, led UN (1998) to conclude that MNEs are inclined to take advantages of the opportunities that exist for transfer pricing manipulations. A glaring instance of tax avoidance through transfer pricing is provided by the case involving the renowned Swiss-based Hoffmann-La Roche and its two highly successful drugs: Libirium and Valium. (Tang, 1981)

Tax authorities fear that MNEs ‘use’ transfer pricing as an instrument of global profit optimization. They argue that transfer pricing provides opportunities to MNEs to shift profits from a high tax country to a low tax regime. In recent years, the tax administrations and policy makers of several countries have become alarmed at the growing volume of international tax evasion, some of which is the result of transfer pricing abuses.

Transfer Pricing in Indian Context

In the last few decades, involvement of MNEs in the economies of developing countries has resulted in a substantial improvement of such economics- both qualitative and quantitative. The developing countries are no longer seen only as a source of raw material, but as big markets for the product of MNEs. Further, owing to cheap labor available in these countries, labor intensive industries are being shifted there by MNEs. Apart from these, the developing countries are adopting more liberal and pro-export economic policies. Consequently, the MNEs are being encouraged to enhance their involvement in their economies of those countries. The format used by MNEs for investing in developing countries include 100 percent equity investments, long-term debt, technological licenses and management service agreement(UN-1988).

The inflow of FDI into these countries during the last two decades has increased almost fourfold. Obviously, with the growing MNEs, interest in developing countries, it has become imperative for tax authorities in these countries to become alive to transfer pricing issues. It is sometimes argued that the problem of transfer pricing abuses peculiar to developed countries and developing countries are not much affected. The reason advanced for this view are that MNEs may refrain from manipulative transfer pricing practices in developing countries basically owing to two reasons:

- Developing countries have softer tax regimes than developed countries.
- In cases where the parent enterprises in resident in a country with a foreign tax credit system, corporate taxes paid in host country can be credited against the tax liability imposed by the home country on remitted profits.

However, these assumptions suffer from several serious flaws. These are:
- The assumption that marginal corporate rates in developing countries are lower is not always true.
- Tax administrations in developing countries are typically lax, which reduce the risk that such abuses in developing countries will be detected.
- Even where tax rates are low, tax havens provide incentives for shifting profits away from developing countries.

Thus with the emergence of a global market, and growth in international trade being increasingly carried through MNEs, transfer pricing becomes as much an issue in developing countries as it is in developed countries. Similarly, in India too, it is sometimes argued that transfer pricing is not an issue to be worried over by tax administrations. The primary reason for this view is that the existing channels for inflow of capital and technology are restricted and that safety mechanisms are built into various laws governing flow of foreign exchange. It is also argued that high customs tariff discourage over pricing import of goods in India.
However, the above arguments no longer hold good. Since early nineties, the Indian economy is undergoing major restructuring and opening up. It is rapidly getting integrated into the global economy.

There has been a spurt in the inflow of foreign direct investment (FDI) in India. Over the years, the yearly inflow of the FDI has increased multifold and the most rapid growth has been since 1993. To encourage inflow of funds laws governing flow of foreign capital of being amended to bring them in line with the international perceptions. Tariff rates are also being overhauled to make them competitive and in line with world rates. Consequently, customs duty may not exceed the income tax rates if transactions are routed through tax havens or complex tax avoidance mechanisms. This concept needs immediate and serious attention by the authorities in India is revealed, albeit indirectly, by the results of a study conducted by Zdanowicz et al. (1996). Analyzing the figure of capital flight from India to US, the author concludes that the economic benefit of detecting and deterring capital outflow related to abnormal transaction prices can be very substantial. Comparing the prices of India’s imports from US to the average import prices of similar product imported from the US by other countries in the world, and India’s export prices to the US to the average export prices of similar exported to the US from other countries in the world, it has been estimated that the income shifted from India to US ranged from $1662 million to $4423 million. This figure includes transactions within and outside the MNE system. In other words, the flight is not only due to intra-firm transactions. However, these are indicative enough of the fact that substantial transfer pricing abuse would be very substantial. In these circumstances, it is indeed natural for Indian tax authorities to engage in devising a system to discourage abuse of transfer pricing without adversely affecting international trade in goods and services and inflow of international funds.

**Conclusion**

India has to have certain additional obligations to meet while deserving appropriate transfer pricing system. While formulating a transfer pricing system, the authorities will have not only to safeguard their revenue, but also to keep in mind that abusive transfer pricing practices affect us in different ways. It may affect a very small proportion of tax revenue in large industrial country but it can affect a very significant proportion of the tax revenue for us especially when there is significant foreign investment in our country. Developing countries like India may find themselves in difficult situations while dealing with multi-national enterprises. While they host only a small portion of the overall activities of MNEs, the presence of MNEs in the developing countries may be extremely important as they need them for investments and technology, which generates employment opportunities and earn foreign exchange of critical importance to the host economies (UN, 1988). This dependence on MNEs puts us in a delicate position if we want to curb transfer pricing abuses without adversely affecting foreign investment flows. If we introduce harsh effective transfer pricing policies, the multinational enterprises may respond by shifting their investments to jurisdictions with relaxed policies on transfer pricing. On the other hand, if they become lenient in enforcing the provision on transfer pricing, they lose substantial revenue. Obviously, the solution does not lie with the introduction of simple anti-avoidance legislative provisions. UN (1988) suggests that in order to introduce more effective transfer pricing policies without discouraging foreign investment, developing countries should follow two ways. First, in the establishment of new transfer pricing rules, developing countries must ensure that the legitimate interest of the MNEs are safeguard. This means most importantly that the developing countries will have to recognize that determination of arm’s length prices is not a science and there cannot be unanimity in this matter.

Second, to compensate for the disincentive effect of rigorous transfer pricing rules, along with introduction of such rules, the developing countries should take steps to improve their investment climate through non-fiscal measures. It needs to be appreciated that MNEs would want to have smooth operational environment and easy conditions for repatriation of their profits from branches to parent
entities. If such conditions are created, then new transfer pricing rules would be less likely to receive a hostile reception. Hence developing countries should introduce a general overhaul of the government bureaucracies dealing with foreign investment with particular emphasis on streamlining the procedures that multinational enterprises have to comply with to invest and operate in the country (Un,1988). Hence, we can say that transfer pricing in India in no longer a distant concept.

References

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