Transfer Pricing : The Systemic Fault lines In Indian Perspective

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Abstract

Transfer Pricing is the general term used for the pricing of cross-border, intra-firm transactions between related parties and associated establishments. Around 60% of world trade actually takes place within multinational enterprises having presence in different locations in the world. With growing global trade, the National Government has made various laws regarding Transfer Pricing, with a view to maximize tax revenues. India, introducing its TP laws in 2001, ranks amongst the top three countries in terms of TP litigation with meager 2 % share in global trade today. Ironically, only 10% of the TP cases litigated are decided in the favor of tax authorities. The legitimacy and efficacy of the tax enforcement becomes questionable with such a mismatch between the additional tax demands (amounting to Rs 46,466 Crores for the year 2014-2015) and the judicial verdicts. This mismatch can potentially endanger the MNCs perceptions about the ease of doing business in India and consequently future Foreign Direct Investment. At the same time, tax enforcement machinery gets demoralized which is not conducive to good governance. This paper attempts to synthesize the issues in transfer pricing as the systemic dynamics between all the concerned agencies viz. the tax enforcement machinery and their procedures, adjudication, tax payers and their perceptions. It also endeavors to suggest an approach for the reforms needed in the system.

Keywords: Issues in Transfer Pricing, Arms Length Price, Categorization, Tax Compliance, Systemic issues

Objectives and Scope of the Study

Transfer Pricing is the general term used for the pricing of cross-border, intra-firm transactions between related parties and associated establishments. Around 60% of world trade actually takes place within multinational enterprises having presence in different locations in the world. India made its first TP legislation in 2001, which was about 10 years after the developed nations, enforced their respective laws. It is shocking to note that with 2% of global exports, India has third largest number of litigations on TP in the world today, with 90% of these cases being decided against the tax authorities. In view of these startling and shocking facts, it became utmost necessary to explore deeper into the causes to overcome this mismatch. Therefore, the research was mainly conducted to understand, synthesize and suggest an approach for reforms, rather than just describe the issues in TP.

Firstly, TP is an issue of tax enforcement as the tax demands from the tax authorities range to the tune of Rs 46,466 Crores (2014-15) per year, ending up in heavy litigation [1].

Secondly, it is also an issue of judicial administration as TP litigation takes 3 to 5 years for getting a judgment at the Tribunal level itself.

Thirdly, it has an immediate context of business economics of global relocation by MNCs, as 60% of global trade happens between two units of MNCs [2].

At the broader level, disputes over TP indicate the contradiction between the global character of business and the local character of tax enforcement.

This contradiction itself turns into a major fault line in the TP taxation. The global flow of economic variables such as goods, services and investments being regulated by the Local states, creates a mismatch between the mismatch between the economic process and the political process. This leads to artificial assumptions of the intra firm prices which in reality may not exist between the related units of an MNC. Consequently it creates an additional burden on the TP officials to look for comparable prices for such goods and services which may not be just available in the source countries. This makes the TP taxation complex, hypothetical, subjective and always open to be challenged in judiciary. Additionally, one deeper dimension gets added to the complexity of the situation when various States of the world start competing with each other for attracting the global flow of investments by creating low tax jurisdictions, also known as tax havens. It is bizarre facts that, two-third of the global investments today are rooted through tax havens which are increasing in number every year[3].
Given the discord between institutions involved in Transfer Pricing, there is an urgent need to reform its systemic process.

SECTION I – Operational Issues in TP litigations

Issues arising out of Recent Judicial views on Transfer Pricing in India

TP has generally been a contentious issue between the Income tax department and the MNCs for more than 20 years world over. It has become particularly visible in India from 2003 i.e. 2 years after the special enactment for TP issues was made in India.
The TP litigation, which has occurred in last decade consistently, shows an upward trend, as evident from the chart below:

Year	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Amt. of Adjustments (in cr.)	1,220	2,287	3,432	7,754	10,908	24,111	44,532	70,016	59,602	46,466
No. of TP audits Completed	1,061	1,501	1,768	1,945	1,830	2,368	2,638	3,171	3,617	4,290
No. of adjusted cases	239	337	471	754	813	1,207	1,343	1,686	1920	2,353

(Source: Statistics appearing in Annual Reports 2013-14 and 2014-15 published by Ministry of Finance)
With about 3,500 disputes, India has the third largest number of pending cases related to TP in the world. This appears even more surprising when the Indian share in the world exports is around 2 present, for years together.
The pending disputes are inclusive of the cases pending with Dispute Resolution Panel (DRP), Commissioner of Income Tax (Appeals) and Income Tax Appellate Tribunal (ITAT).The report further

states "Based on the current caseload of TP reviews, the top five jurisdictions (in order) are Japan, Canada, India, Germany and the United Kingdom "

The main observations from this flood of TP litigation in India can be summarized as follows:

1. That, of all the cases referred to the TP officers, more than half end up in upward adjustments (demands from officials) in the tax payable.
2. Those, almost all the tax payers in the cases, wherein such an upward adjustments are made, prefer to challenge these additional demands for taxes at the judicial- quasi-judicial forums which take about 3 to 5 years to be decided on an average.
3. That, of the cases referred to these judicial and quasi judicial authorities, only 10 % cases are decided in favor of the tax authorities, 69% in favor of tax payers and others fall in the partial relief to both category.
4. That, the net result of this TP litigation is discouraging for the State as it does not add to the revenue significantly; and additionally they also have to pay interest to the litigant tax payer which may exceed the extra tax demanded.
5. That, it does not benefit the tax payers as well, since they too are required to spend on the litigation, lock up their funds in paying 50% of the adjustments as deposits and also have to put their pricing and investment decisions on hold till final judicial clarity on various issues is obtained.

Thus this area of study needs penetrating analysis and synthesis of the current issues over which such a large number of disputes is arising, along with the outcomes of these profusely outnumbered litigations. With an extensive discussion with experienced officials in the Tax Department, MNC executives and also the Chartered Accountants dealing with the TP cases, following may be a broad summary of the issues involved in the disputes. These issues are classified on the basis the potential profit manipulation and its effect on tax liability.

1. **Pricing of the Shares issued to the parent / associated companies**

   One of the most important issues, over which many high profile high value TP cases have been decided in the Supreme Court and High Court, is on pricing of the shares issued by the subsidiaries in India to their Holding companies abroad. These cases were based on the loopholes in determining the appropriate Arms Length Price .The two prominent recent cases were—The Vodafone case and The Shell Company case.

2. **Payments of Royalty, Patents and other Intellectual Property**

   Payments made by the Indian firms to their associates by way of Royalty, Patents and charges for Intellectual Property (IPR) fall in the category of intangibles, in terms of taxation and accounting . It is very difficult to have a rational evaluation of the same due its most abstract, extremely technical and deeply subjective nature. More so, it is shrouded in secrecy which makes any legitimate enquiry into its legitimacy very difficult. The MNCs investing in India have been doing research, developing and registering the designs and formula of their products generally in Europe and US. However, of late, they have been shifting the registration of the IPR to the tax havens to avoid taxation in US and European Union. It has always been issues of debate in India for long, mainly for two reasons viz. the justifiability and the quantum of payment. It came to the floor with liberalization since 1992, with more MNCs locating their production units, in India. However, before 2009, royalty was regulated by the Indian government and was capped at 8% of exports and 5% of domestic sales in the case of

technology transfer and fixed at 2% of exports and 1% of domestic sales for use of trademarks and brand names.

All these restrictions were removed in 2009 to make India an attractive destination for MNC investments and since then there has been a spate in Royalty payments from India. This has increased to the extent that the earnings of the parent MNCs through dividends have been surpassed by these IPR payments.

Another evidence to complement these findings can be stated by the fact that 71 MNCs (whose financial numbers are available till 2012-13) earned a combined Rs 4,838 Crores from their Indian subsidiaries in the form of royalty and technical fees. In comparison, their total dividend income was Rs 4,529 Crores. The government is concerned that in many instances the royalty route is being used to siphon out profit even when there is no transfer of technology or critical components and designs that could add to the competitive edge of the Indian company. In many cases it is clearly evident that foreign collaboration has been used, only to sell a brand through the use of trademarks.

3. **Payments for Management- Services Fee Payouts**

The issue of payments made the Indian counterparts to the management personnel coming from the associated companies or for the services rendered by the parent or the associate companies are subjected to examination of the TP authorities. There is a possibility of making unjustified high payments, amounting to siphoning out the profits from India. It may also be an attempt to book the salary-fees of a person not rendering service worth it in India and actually receiving his services elsewhere outside of India**.**

4. **Allowing the expenses made for Advertising, Marketing, And Promotion(AMP) of the products of MNC s in India**

Another major issue involved in TP is the disproportionately high Advertising Marketing and Product promotion expenditure made by the Indian associates of the MNCs. This may involve an issue of foreign brand names of the parent company being advertised in India without appropriate benefit to the Indian associates. Thus Indian associates spend a significant amount on AMP expense benefitting the Associate Enterprises (AE) by creating marketing intangibles without benefit /corresponding compensation/ reimburseme The tax authorities have been contending that such non-routine marketing efforts of a subsidiary of the MNCs should be categorized as “Service” rendered to their AE and accordingly, should be compensated for the same. This non-routine expenditure is presumed to create marketing intangibles, which benefit the legal owners of the brand and not the local Indian affiliates. In such cases, Revenue authorities compare expense to sales ratio of the assessee with other comparables and disallow AMP expense in excess of “bright-line” (meaning an allowable limit of expenses) as TP adjustment, alleging contribution by taxpayer, is towards strengthening foreign AE owned brands.

SECTION II- Broader Issues in Transfer Pricing

To rationalize the peculiarities of the systemic dynamics between the institutions in TP a broader understanding of the current scenario would be necessary.

1. **Base Erosion and Profit Shifting**

Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike[4]. While there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting[5]. The concept of base erosion arises when the Government is unable to procure the actual revenues in terms of taxation from their legit base of population due to reasons like the inherent moral hazard of companies to reduce their tax liability in order to make profits to incentivize their shareholders. This creates a possibility for companies to look for alternatives to avoid taxes by shifting their overall profits to areas of lower tax jurisdiction countries i.e. tax havens by creating subsidiaries. They usually use the double taxation gateway to justify these unfair transactions. This poses a great danger to the Governments revenue collections as profits are misappropriated and it gives rise to higher tax evasion prospects. Broad support in the international community for action against tax avoidance by MNCs has led to a G20 initiative to counter BEPS, led by the Organization for Economic Co-operation and Development (OECD)[6] .The BEPS focuses on methods used to modify tax rules to prevent multinational tax avoidance. The world economies are exponentially expanding in their every day demand and investment requirements. On one hand, the tax authorities are trying to prevent tax avoidances but on the other, they are obligated to do it in a way that it doesn't harm the sustained investment which is dearly required for the world growth and development. The World Investment Report, 2014 (WIR14) showed the methods adopted in developing countries public investment which were insufficient to cover an estimated $2.5 trillion annual investment gap in productive capacity, infrastructure, agriculture, services, renewable and other sectors[7]. Thus, the need for private investment from MNCs to increase is a basic requirement for the world development agenda. Thus the tax authorities need to find the right amount of tax to be charged, at the right time, in the right place, to the right people, without harming the investment base. Therefore, the BEPS 15-point action plan has definitely benefited the world at large. It is highly relevant in India, especially with the plans regarding the treaty abuse, permanent establishment, intangibles, documentation, etc.

The same report observes further that the annual losses at the global level due to BEPS would be between 4-10% of global corporate income tax (CIT) revenues, i.e. USD 100 to 240 billion annually. This is the reason that G20 nations, of which India is a member, have taken a serious view of the situation and has decided to re-write the corporate taxation laws so as to prevent such a phenomenon, which is eroding the efficacy of the taxation system.

In view of the magnitude of the problem at the global level, no wonder that TP officials in India have made upward adjustment amounting to Rs.700 billion ($10.8 billion) for the year 2012-13[8]

The Action Plan on Base Erosion and Profit Shifting (OECD, 2013) identified 15 actions, along three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards and improving transparency, as well as certainty for businesses that do not take aggressive positions.

Till 1990s this was the issue faced mainly by the developing nations alone, as the profits made there, were shifted to headquarters. However, with the advent of liberalization of trade and finance, and with the creation of tax havens all over the globe, the developed nations also started the same problem of erosion of the tax base. Hence this issue became a major OECD issue and initiative.

Specifically from India's point of view, this issue is of vital importance. The Tax-GDP ratio of India is barely 17%. It is also observed that it is not buoyant as against the rising GDP growth rate of 8%. Therefore, in spite of the rising GDP of the nation, the State continues to lack the necessary rules for the democratic governance, infrastructure building and the heavy backlog of social sector development. Thus, the initiative taken by the Indian State, in regulating TP for last 15 years, gets fully justified, at least in its objective.

Ease of doing business

The economic variables that constitute business, such as capital, technology, human resources have become extremely mobile after globalization. Thus, capital investing MNCs have an opportunity to choose the country, in which to locate their units, in terms of the ease "they find" in doing business there. Therefore "Ease of Doing Business" has become a comparable yardstick, which the MNCs apply, to choose as their business destination for particular business operations from production to retail. There are many parameters which MNCs consider to arrive at their conclusion, and one of the inputs for the same, is operation of the tax system. TP regulations, by questioning the pricing decisions of the MNCs in their intra firm transactions, may actually question the very economic logic of deployment of investments by MNCs world over. The MNCs motivated by the genuine business profits, and in search of resource economization, require a certainty of the TP regulations and executive enforcement. If the TP enforcement starts turning into long litigation alone, they might feel threatened by the same. Thus, India is not considered to be a preferred destination for global manufacturing investments, mostly for infrastructural deficit. It can be further avoided if the uncertainties regarding the interpretations in TP regulation, keep on changing as per the officers subjectivity and the arbitrary adjustments. The difficulties are experienced in the TP litigations, of which 69 % are decided against the Tax authorities. The prolonged litigations, if not properly founded on research and data, may force them to divert their investments from India to other destinations. It should also be noted that even if the cases are decided in favor of the Assessee companies, they still have to bear the loss of opportunities as their cash flow of capital gets locked up in the advance payments of additional tax demands to be made till the cases are finally decided.

2.Political dilemma & laxity in action against irregularities

India's policy and enforcements of the TP policy norms must be examined in the perspective of the economic dilemma, the State has to face. The State feels compelled (although questionably in certain fields at times) to increase or at least maintain its meager share in global flow of MNCs capital investments. As seen earlier, India, except for Information Technology sector, is not considered to be the first few destinations for such investments, in view of serious lack of infrastructural development. Now in order to attract them in spite of this deficit, India, attempts to attract these investing MNCs by offering tax enforcement through certain laws and regulations, as a counterweight. This may include TP regulations as well. It therefore becomes a political choice of the State whether to choose the investments at any cost or to insist upon the strengthening the tax enforcement including TP machinery. Thus we find two contradictory processes happening at the same time. TP officials at the lower levels continue to make adjustments in large magnitude and that too in large number of cases. But they lack the support of adequate human resource input and data information from the State to have tax enforcement machinery in place.

SECTION III - Analysis and Interpretation

This research has used a combination of unstructured interviews and structured questionnaire. This study uses a semi-structured methodology with a purposive sampling as the population was selected on the basis of the expertise and experience in the subject. The MNC Management population was selected on the basis of the main activity of the firm, being export and import. Further the interviews were taken from the Income tax officials, which were selected on the basis of their experiences in the TP Department. (Appendix 1)

Perceptions and Responses

1. From Management of MNCs

In the course of the survey there had been interviews and informal interactions with certain MNC Executives- MDs and Finance Heads.

It was held that TP is a comparatively new concept and the special provisions for the same were introduced in the IT Act in 2001 and was a positive step taken by the Government as with globalization, regulations and the need for an intensive regulation became necessary. However they said interviewed corporations in their practice, on its own accord, had been cautious about the principle of Arm's length Pricing and followed it even before any enactment had been made in this regard. However the new laws created a new vacuum in the tax departments.

The experience of the tax enforcement by MNCs

As regards Transfer Pricing Official (TPO)

1. As the tax department did not have the expertise to conduct examination as envisaged in the laws, the spirit of the law was not contained in its actual practice. It is observed that the TP examination has been converted into a practice of making absolutely unfounded, unrealistic assumptions which changed every year as per the arbitrary interpretation by the officer concerned and tax demands based upon that. It became a tool to intimidate rather than regulate with a business sense. As a result, erroneous orders were passed; incorrect decisions were taken, which were reversed by ITAT, HC and SCs making Government pay heavily in the form of interest payments.
2. The system devised was such that it created a fracture between the MNCs and the Government as tax payers and pay collectors respectively. In fact there was a `need for a system, creating synergy of both the parties. The Executives expressed that idea introducing the law was not to make it look simple but to make it practically work. The TP officers in absence of clarity of concepts and knowledge were inconsistent in their interpretations and application of the terms which prejudiced the ease of doing business substantially for the MNCs.

As regards Assessing Officer (AO)

1. The TP report is made by the TPO, a particular interpretation and application of the ALP is done and presented to the AO who generally follows the same interpretation and culminates the report into an Assessment Order.
2. In case of dissatisfaction with the Assessment order, the company can go to the DRP (Dispute Resolution Panel) or directly move to the Tribunal for adjudication. DRP is the authority which resolves the disputes relating to TP in international transactions. Before the formation of DRP, the MNCs had to approach CIT (A)-Commissioner of income tax to appeal against the assessment order but with the formation of DRP, the MNCs can directly approach them with objection through the draft order made by the AO within 30 days.

As regards Dispute Resolution Panel (DRP)

The issue as regards DRP arises due to following reasons:

1. The panel comprises of 3 commissioners of income tax appointed by the CBIT i.e. there is a natural bias of revenue collection over and above the genuine issues. Lack of expertise in quantitative aspects of the subject. Many a time a bad rapport is created between the Government and the MNCs.

2. It is observed that the tax authorities operate on the instruction to increase the revenue collection in the given time frame. In order to realize the same, they force the companies to pay the taxes with the highest possible tax rates, at the most unfavorable unrealistic assumptions to the MNCs. This resulted into higher tax collections and more and more litigation before the Tribunal. Even though the Government succeeds in collecting a higher amount in the initial stages, such an unrealistic approach ends up in reversal of the assessment made by the revenue authorities, making the Government pay back the tax so collected with an interest ranging around 10%.Thus finally such an approach results in a "lose- lose" position for the company as well as the Government

As regards Tribunal

1. When the companies are not satisfied with the decision of DRP as well, they prefer an appeal to the Tribunal, which is a judicial authority. The approach of the Tribunal is generally found to be realistic, understanding and sticking to the latter by the law, rather than "broadening the tax net" somehow as found with the revenue authorities.
2. There is a panel of highly skilled personnel, comprising of members from the Ministry of Law and Ministry of Finance. This is indeed a way forward to progress but even this hampered the process as these tribunals are highly overworked and burdened. The cases take about 8-9 years to get final judgment which causes huge loss on the part of the Government and the MNCs.
3. High Court and Supreme Court are only involved in the appeals on the legal grounds. Technical issues are not entertained by the HC and SC.

Summarization of the TP issues as emerging from MNC executives:

- Lack of consistency in calculation of the comparables in calculating TP. The interpretation changes from year to year and from officer to officer. This results in non-predictability of tax liability and therefore hampers the ease of doing business.
- Lack of long term easy approach with regards to TP policy.
- The possibility of Double Taxation in certain cases- Sometimes it may be possible that while making the assessments, the sale's price of an export made from India is treated to be notionally higher than what is actually shown in the tax returns by an associated company in India, in its exports to another associate of the same group. This may result into higher payment of tax in India than what is actually payable as per the books of accounts of the company, due to the presumption of higher transfer price than as per the books.
- However, in the books of the importing counter part of the same transaction referred above, the price of purchase from India continues to be the same as per the invoice in the books of accounts. Thus, the importing company ends up with a higher margin of profits, which is the difference between the said import price and its selling price, by the importing company as per its business contracts. Therefore, it results in double taxation on the same margin of profit. Once it is taxed on the notional basis of higher export price in India, it is taxed second time by the actual profit margin in the importing company.
- Lack of business sense and expertise in the Tax authorities -- New positive Dimension of APA and MAP has brought a great deal of ease in legal calculations of TP. The two tax authorities devise the price adjustment which is not binding in nature. If it is approved and agreed upon, it can follow up on the same prices for 9 years without any legal hindrances. These provisions are so intricately designed such that there is no revenue leakage in the economies between which the

international trade takes place. The tax officials consider the business perspective along with their revenue perspective while passing the judgments. This gives room for a just and fair judgment. It is a way forward as it is of a positive view for the Government and the MNCs. As the Government should understand that this-incentivizing MNCs by oppressing them through complicated tax regulations will only hamper their business growth and the Government's revenue base. As the cases which are filed, usually take 8-9 years, for which the company's funds are blocked in the mesh of the Government's treasury- neither used by the Government for any useful purpose nor can be utilized or invested by MNC for the business's growth. This creates stagnation of funds which causes revenue loss for both but on a broad basis mainly to the Government. The Governments should look at this issue from a holistic point of view and not to view it from a tax collector's point of view.

- The tax authorities work on a wrong perception that Companies work on the principle of tax evasion rather business efficiency, growth and prospects while the reality is exactly the other way round.
- The TP provisions are indeed a boon from the Government and MNC's point of view. It provided a good discipline and a thinking base for the potential and existing MNCs. As a concept it is certainly very effective, but only its implementation and the practical aspect need to be worked upon.
- The MNCs have a deep concern after the Vodafone case as the retrospective tax scheme gave the world business a jolt, in terms of ease of doing business. As already stated these cases were hugely penalized and perennial delay in the judgments caused huge losses to the firms. The loss to the business through law evasion is way more than the profits they can make by evading taxes.

2. From Tax Officials

The tax officials interviewed were senior and experienced, having dealt with the TP processing and the scrutiny for significant time period. The conclusions on the basis of their TP scrutiny can be summarized as the following:

1) They agreed that the proportion of the experience of TP litigations to the cases scrutinized is substantially high and needs an urgent attention.
2) They were seriously cognizant about the fact that almost all the TP adjustments made by them are reversed in the judicial judgments.
3) The probable reasons were given as:
   - The TPO relatively lack in formal training in this branch of highly specialized taxation which has evolved very recently and still is at a nascent stage of practice.
   - The TPO deployed at their positions require considerable time for online experience to get the grip of the subject. However, there services get transferred in the usual bureaucratic cycles without special considerations of without the job profile of a TPO.
   - As per the organizational model followed in the Dept, the services of external experts and advisors are not available, to the TPO in operation. Therefore, the fresh expert input of the global judicial view, best and the bad practices, the possible loopholes etc are not available to the TPO except those coming from the hierarchy of organization. On this background, on the contrary, MNCs are highly prepared and supported by back office data and the updates of global scenario.

- The number of scrutiny files to be handled by TPO is very large in numbers and that too, to be concluded by an individual officer, without a horizontal teamwork and expert inputs. This in turn, affects the quality of scrutiny and conclusions thereof.
- As a result, the adjustments made by the TPO lack the essential foundation.
- At the judicial level, the TPO have to fight their own cases without appropriate expert representation to match that of the MNCs.
- Consequently, the TP litigation ends up in loss for the Income Tax Department. The cases are lost by TPO not because they lack substance: but because they lack expert processing and legal packaging.
- Many a times, TPO are giving quotas for raising adjustment demands which prejudices their individual judgments.
- The officials expressed a total agreement with the categorization of the taxpayers, akin to ethical classification. However, they were apprehensive about the certifying authority.
- They particularly pointed out that the western countries have lateral entries for experts in the formal live organization of IT. Hence, there adjustment demands are extremely focused and fool-proof, as the taxpayers are aware that any adversely concluded enquiry by the tax authority is taken to its logical end of prosecution. The tax payers automatically become tax compliant. On this background, they stated, In India, too many scrutinizes without discretion to differentiate between the taxpayers on one hand and lack of organizational support/ resources to take the adversaries to the logical end, deprives the Income tax Department, of its teeth.
- They also held that the policies of MNCs are extremely secretive, non transparent and decided at their global headquarters with global information and plans. It becomes very difficult for the TPO to forecast the probable changes in the said policies and their outcomes.
- Finally, they recommended a complete overhaul of the IT organizational set up, with human resource development and back up support of experts as the key driving factors.

3. From Chartered Accountants (CA)

The interview and the questionnaire's response from the CAs, regarding the current issue in TP, gave an in-depth firsthand experience, from their point of view.

They stated that as the law was new and the issue was complex, all three participants i.e. the Executive (Government), Legislature (Parliament), Judiciary (Courts) and media has completely lost themselves in the mechanistic nature of the law. It was conveyed that the subject matter of the law was lost in the wilderness of procedural compliance. They expressed their concern regarding the law, becoming a mechanical exercise and it had ended up with no substantial matter and practicability. The taxpayers and the tax authority are equally unaware of the cause and effect of this issue. Thus, they need to discuss the issues on a leveled plane before they reach out for the "judicial outcomes".

- They were very convinced and approved the fact that the laws in India were adequate and appropriate. Hence, they emphasized the fact that the drawback with the laws was not their framework, but their proper and efficient enforcement. The common perception that prevailed was of a failed legal system, which created the TP laws for a cause, but is now lost in the minute mechanistic aspect of the issues.
- A major concern expressed was regarding the way of scrutiny i.e. the methodology of the way the legal procedures were undertaken. This was precisely pointed as a reason for such high litigation in such a small period of time. There is currently no sieving of the cases as per the seriousness, the companies with turnover more than 150 million are under the scrutiny net of

TP, thus a large number of firms directly approach the courts in case of any dispute, which overburdens the Department.

- Another issue, regarding the problem under discussion, was the fact that there was extensive hypothesizing in the department on constructing the price. The respondents gave us an insight into two schools of thought/ critics that prevailed in defining the ALP. One school believed in the current system and accepted subjective approach to define ALP according to the nature of transaction, nature of the enterprise, economic circumstances, business strategy, and availability of data, degree of comparability, reliability and accuracy. The other school of thought opposes the prevailing system and insists on having a Global Formulary Apportionment, which is basically a formulae based approach to calculate the ALP so that there is no subjectivity left in the hands of the MNCs. Both the critics have their own advantages and drawbacks.
- The view of CAs regarding the TP and tax evasion equation was very clear. They stated The introduction of the law was indeed a sigh of relief. But the TP practices, which followed the law, became a black hole. The TP law is more appropriate and relevant today, as it is fundamentally perfect but lacks implementation practices. Thus, it acts as an anecdote to tax evasion.
- They were very optimistic about the categorization proposed for the MNCs but they were not quite sure of the implementation of such categorization. However, they welcomed the concept fundamentally and agreed on the success in this proposed differentiation.

The maze of litigation arising in TP reflects discordant visions of the tax authorities and taxpaying MNCs. Since the application of general principles of taxation to specific conditions of international business is itself an onerous task to be executed without disputes between the parties. E.g. principles and practices applicable for TP issues in manufacturing units cannot be applied in the same proportion to the service oriented MNCs. Therefore, this paper suggests an classification of MNCs as follows for TP purposes. This classification is based on the nature of business and the tax situations.

The categorization of the associated enterprises can be done as:

1. **Patent Based –** This is a category of the companies wherein the highest value addition is made by the intellectual property rights (IPR), vested in patents, copyrights, designs, etc. While applying TP scrutiny, such companies would be compared and assessed with an understanding of the nature of the IPR involved with its appropriate comparables .This can be concretized by introducing an idea similar to the " harmonized system" which is used in Customs procedures. However, the problem of excessive detailing and differentiation shall have to be prevented from tripping into the system. e.g. Patented pharmaceuticals, Audio and visual productions.
2. **Brand Based –** This category covers those associated enterprises whose predominant business involves the brand names for which the products are principally purchased in the market, rather than based on the intrinsic material qualities of the product .e.g. Nike, Starbucks.
3. **Generic Product Based –** The products not having prominent brands or IPR and are easily imitable in terms of its essential outlook, shall fall under this category. E.g. Generic medicines, FMCG.
4. **Jobbing Based** – The enterprises which produce or fabricate machines – product, as a job work to be completed as per the customized design and orders, fall under this category. E.g. IT companies, Engineering Fabrication units, Captive production units.
5. **Service Based** – The enterprises which specialize in providing specific support services such as consultancy, back office, research, maintenance etc.

There is a need to understand that the situation currently prevailing in TP today, needs careful examination. Almost all the respondent experts in TP as well as the department officials agree unanimously that TP regulation in India is in utter chaos. The litigations, reaching more than half of the cases scrutinized, do not indicate good tax enforcement & administration; but exactly its opposite. The cost of the State executive, judiciary and legislative is simply going to drains without leading to any significant rise in the revenue collection. In fact, India's ranking as third largest TP litigants, with less than one and half percent share in the world exports speaks volumes about the way the system is handled.

This is not to suggest that the tax demands made by the tax authorities are necessarily unreasonable or unjust by law, but it shows that there exists a complete lack of tuning and matching in the three wings of the State viz. Executive, Judiciary and Legislative. It is as bad as right hand being oblivious of the actions of the left hand.

Conclusion as regards TP enforcement machinery

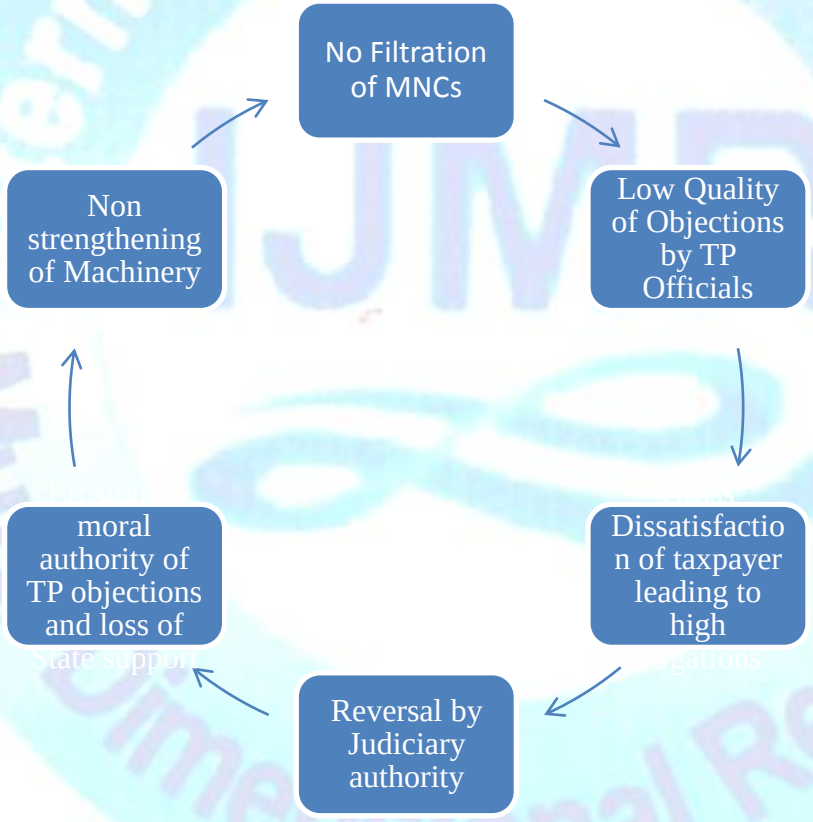
Based upon the statistics and the inputs from the expert officials, it can be concluded that:

1) **Adequate Legal Provisions**- Legal provisions for TP regulations in India are more than adequate .The law is extensively elaborate and detailed .It is very wide in nature and thus increases the probability of loopholes. The wide definitions cover too many areas such that it gives opportunities for the taxpayers and the tax authorities to interpret the law in a different manner according to their benefit.
2) **Lack of sufficient Machinery** – Even though a separate department has been created in direct taxes for TP, it lacks sufficient number of officers with expertise and experience in the related field. More so, the TP officials, just as other officials, are transferred by rotation even before they master this new and extremely difficult branch of international taxation. There is a lack of primary filtration of cases for scrutiny, leading to every case being treated with same perceptions of suspicion and distrust.
3) **Work overload for the TP officers and related department-** The TP department is required to handle every case coming to it for scrutiny. Statistics reflect that the number of cases scrutinized had increased from 1,061 in the first round of audit in FY 2005-06 to 4,290 in FY 2014-15 .Given that there are approximately 50-60 TPOs pan-India, it implies that every officer audits more than 70 cases. This shows that there exists dispersion of attention from the tax authorities, as the TPOs are already overburdened and also not supported by the senior authorities. This creates a moral paradox for the TPO. In view of the complexity of the MNCs global business and non – transparent policies decided outside India and also need to collect very wide range of information globally, the workload for the TP officers prevents him of going into deep study and conclusions affecting the quality of the scrutiny and objections raised adversely.
4) **Poor Data base and back office support-** The TP office lacks the back office support in terms of team work, consultations, data bases, information of the global tax developments. This stands in complete contrast to the MNCs they have to challenge. The Department faces an asymmetry of information as the MNCs have an informative advantage over the authorities. As a result, in spite of valid intelligent objections raised by them, they stand a very poor chance of justifying their objections for the lack of sufficient data and articulation.
5) **Lack of Moral Support from the Top of the Govt.**- It is observed that due to the propaganda machine in the hands of MNCs and almost no means of publicity available to the TP or even the department, MNCs have been winning a propaganda war against the revenue demands and the

State. This, along with the poorly fought –and lost court cases due to the factors referred above, makes the Tax authorities lose its moral position and create their image as being unfair.

The following conclusive factors are very closely linked, creating a general tendency of disbelief in the tax authorities, due to the high number of pending cases challenged and the poor quality of research and scrutiny. Once the reversal judgments start occurring, it has a cascading effect, resulting into a vicious cycle. After and in depth understanding of the subject, the issues and the drawbacks, a model has been devised which depicts the vicious cycle in which the tax authorities and taxpayers will be lost exponentially, until corrective steps are taken promptly, to resolve the issue. The TP litigations have to be understood as a dynamic process, rather than a static reality.

The following process depicts the agencies, their inter relationships and overall outcomes of their collective picture.



1. No Filtration of TP Cases

Thus, we can witness that there are large number of TP cases scrutinized at the TPO level, with minimal back up and data support. There exists no sieving procedure to filter the applications for the TP examination and arrive at the cases to be focused upon urgently or given priority. This leads to high number of cases to be scrutinized.

2. Low Quality of Objections by TP Officials

Due to disproportionately high and indiscriminate number of cases to be scrutinized, the quality of the TPO scrutiny and the nature of objections raised by them is lowered, in terms of judicial interpretation and global business practices.

3. Gross Dissatisfaction of taxpayers leading to high litigation

The TPO, though not lacking in substance, are many a times unable to articulate and present the adjustments made by them to the MNCs income. It leads to gross dissatisfaction of taxpayers. The TPO ends up in making adjustments in 50% of the cases, scrutinized by them. This adjustment being of very high magnitude, distorts the MNCs financial planning and projections of profits/ tax liabilities. It leads to almost all such adjustment cases, being litigated at the appropriate forums, by the MNCs.

4. Reversal by Judiciary authority

With such a lacunae in the objections and the adjustments (although not necessarily lacking the substance), it has been found, in only 10% of the cases, the fate of the litigations challenging them, is more than the pre-written. Inevitably, most of the cases so litigated go against the tax authorities in spite of their legal substance and merit.

5. Erosion of moral authority of TP objections and loss of State support

Such a large proportion of reversal of adjustments/objections made by TPO to the tax liability of the MNCs leads to further drying out of the resources to the Income Tax Department, particularly TP. The moral strength of a TPO gets compromised due to the reversal by the judiciary on one hand and dislike from the political authority on the other.

6. Non - strengthening of Machinery

Finally instead of the TPO getting strengthened in terms of resources, manpower, expert inputs and team work, it is forced to deal with more number of cases with lesser resources. Therefore, it has to continue the work with large number of cases, without filtration. And the cycle continues perpetually.

SECTION IV-Conclusion and Suggestions

- **Conclusion and Suggestions**

  Having taken a systemic view of the challenges faced by the enforcement machinery in TP and the experience of the MNCs with regard to the same , litigations and its outcomes, the following conclusions emerge thereof:

1. **Need to bridge the serious fracture in the system of governance**
   The complexity of the issues in TP has deprived the governance system of its cohesive focus and consistency. This is almost close to challenge the very legitimacy of TP taxation. This has to be overcome with urgent steps of systemic introspection and correction.

2. **System Overhaul -**These steps may include expertise training and orientation of the TP officials, stability of their tenure, research and analysis of the judicial decisions and measures to overcome the reasons for failure of TP cases, restructuring the TP department as a team work

rather than an individual investigation, adequate staffing, ongoing stable legal support to the TP officials may be a few to mention. To obtain efficiency and effectiveness, the Indian systems need a systemic renaissance to cope up with the global taxation standards and processes.prevalent distrust between the taxpaying MNCs and TP enforcement should be bridged so as to avoid disputes and litigation.

3. **Bridging the disconnection between the Judiciary and the TP Department**
   The magnitude of litigations and the outcomes thereof, demand an overall review the tax enforcement system, particularly with reference to the TP issues. The complete disconnection between the Judiciary and the Tax department needs to be bridged by the state, till the apex level.

4. **Preventing the distortion of rational economic choices**
   The cost of failure in tax governance and compliance is heavier than is apparent. It leads to perpetuation and promotion of tax evasion and shift of the tax base from one country to other. It leads to cross border transactions being made, for the purposes of tax evasion, rather than economizing the resource consumption and efficient production. It distorts the rational economic choices.

5. **Encouraging tax compliance through categorization**
   The maze of litigation arising in TP reflects discordant visions of the tax authorities and taxpaying MNCs. Since the application of general principles of taxation to specific conditions of international business is itself an onerous task to be executed without disputes between the parties. There is a need for a classification in terms of the type of business, so that the inherent difference in the workings of different organization is accounted for and further catered to, before any litigation.

6. **Overcoming the frictional imbalances between the local tax and global business- Global Formulary Apportionment**
   The present TP regimes, as well as the MNCs, negate the economic reality for their respective objectives in opposing directions. MNCs, in order to avoid the due tax liability in source country create a fiction of tax residence in a low tax countries or tax havens; while the TP officials create another fiction called arms length pricing and independent business units even in an MNC which has an integrated and organic system of business operations. Thus the real disputes between the MNCs and the TP officials in fact, are nothing but the clash between two fictions, both negating the actually existing business economic realities. This is the one of the major systemic fault line in TP taxation. Thus, global formulary apportionment holds tremendous potential to fill this systemic hiatus.

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Appendix 1

1. Questionnaire

Respondents	**Questionnaire**
Chartered Accountants and Chartered Secretaries	20
Legal Associates and Law Academicians	2
Finance Managers, Analysts and Finance Academicians	8
Total	**30**

2. Interview

Respondents	**Interview**
Income Tax Officials	3
Company Management	3
Total	**6**