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Rethinking transfer pricing

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Taxation of international transactions is a contentious issue and policymakers attempt to balance law and economics while enforcing transfer pricing (TP) provisions. Subjective administration and micromanagement of international transactions by tax authorities under the TP provisions have led to greater litigation and uncertainty. Considering that international transactions have more to do with economics, it would be well to pay heed to Adam Smith before administering TP provisions!

In 1776, Adam Smith had written that specialisation and division of labour led to better utilisation of scarce resources. Expanding on this principle, David Ricardo explained about comparative trade advantage wherein countries that had skill-sets for a particular trade were better off specialising in that trade over another in which they lacked requisite skills. Citing the example of England and Portugal, Ricardo argued that England and Portugal benefited from a trade where England sold cotton and Portugal sold port wine. With the passage of time and greater dissemination of information, pricing strategies evolved and moved from being a function of bargaining power to strategies that incorporated nuanced economic concepts of intangible rights and benefits. Business process outsourcing is an example of how these principles are applied in goods and services and are applications of the Smith-Ricardo principle of specialisation. For example, the iPhone is designed in Silicon Valley, its chips are manufactured across South East Asia, the assembly of phone itself takes place in other parts of Asia and the research centres are across India and Eastern Europe.

Pricing of goods and services is also determined by economics. The manufacturer and sub-contractor have a “not higher than” and “not lower than” threshold respectively and seek to achieve that perfect price. While economists have attempted to work out models to ascertain an equilibrium price in the real world, what is to be noted is that manufacturers and service providers expect and count on repeat orders and price goods and services accordingly. In this complex web of economics, TP provisions under India’s Income Tax Act of 1961 attempt to circle squares by addressing economic issues with a constrained reading of the IT Act.

Global integration of markets enabled companies to acquire or hive off entities that performed the sub-contracted tasks, in keeping with the Smith-Ricardo principle of specialisation. However, the apprehension of governments globally was that related party transactions were likely to be artificially designed to defeat taxation laws. Interestingly, there is no report of either the UN or OECD that documents how much tax revenue was actually lost due to transfer mispricing. TP provisions were incorporated in the IT Act to address the issue of transfer mispricing in related party transactions and ensure that international transactions are priced at levels that do not affect tax collections in India. But the straightjacket formula adopted by TP provisions that seek mathematical precision on price computation does not exist in the realm of economics. Pricing under economics is influenced by several factors ranging from bargaining power, apportionment of transaction risks and rewards, accrual of intangible benefits etc—none of which are valid pricing considerations under India’s TP provisions. In the LG Electronics India Private Ltd vs Assistant Commissioner of Income Tax case, the Income Tax Appellate Tribunal (ITAT) ruled that advertising, marketing and promotional expenditure incurred by an Indian entity in respect of the brand of its foreign associated enterprise (AE) creates intangible rights for the foreign AE. This ruling is contrary to the general understanding of advertising and branding. The assumption that advertising and marketing expenses relatable to the brand of the foreign AE creates an intangible right in favour of the foreign AE is without economic or empirical evidence. Similarly, the principle that emerges in the ruling of another ITAT in the Capgemini India Private Ltd vs ACIT case that economies of scale is not a valid factor while ascertaining comparable profit margins is the very antithesis of economics! Sub-contracting of certain processes that are recognised as justified transactions in indirect tax laws are minutely scrutinised and every decision of a taxpayer is second guessed under TP provisions.

The administration of TP provisions proceed on the basis that the taxpayer's valuation is incorrect and it needs to be rectified by identifying functions, assets and risks of the taxpayer. While taxation on a presumptive basis is not unknown to fiscal laws, the error of the TP provisions is that in an attempt to apply principles of economics, it manifestly fails to do so. So, the subjective administration of TP provisions has led to increased tax litigation, greater uncertainty and a nightmare for companies trading with related enterprises. Ironically, transactions with related parties under the Customs Act, 1962, provide for more certainty and objectivity. Under the Customs Act, value of imported goods is the 'transaction value' of goods similar to the imported goods. This principle is to be applied even when parties are related unless the customs department is able to show that the relationship has affected the value of goods. Litigation on transaction value is neither as frequent nor contentious as litigation in TP.

Another fallacy of TP provisions is that it proceeds on a near-axiomatic principle that the relationship between the parties emphatically affects pricing and that a perfect price can be ascertained with mathematical precision. The assumption that related parties undervalue transactions is conjectural and not on the basis of reliable economic evidence. For instance, there is no study conducted, none relied upon by Parliament and none cited in any court regarding tax revenues lost as a result of mispricing. Unfortunately, legislating in the absence of economic and empirical data isn't uncommon in the context of tax laws. The Report of the Public Accounts Committee on Tax Administration notes that finance ministry officials admitted there was no study on whether tax exemptions had helped in the growth of the economy.

The solution to addressing transfer mispricing must be to first identify instances of price distortions in related party transactions. The one-size-fits-all approach is fundamentally flawed while dealing with economic transactions and fiscal laws and is counter-productive. The irony of tax litigation in India is that the companies that litigate are those that are making bona fide attempts to comply with the IT Act. Undoubtedly, loss of revenue to the nation is a serious issue that must be addressed but a better understanding of the loss is required before legislation is passed to address the issue. Without economic and empirical data, no policy can be effectively addressed and fiscal laws are no different. A better approach would be to adopt the approach under the Customs Act which casts a clear obligation to positively identify price distortion. A holistic and non-adversarial approach would help bring down litigation and ensure greater compliance—salutary features which are of benefit for the taxpayer and the country.

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