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Transfer Pricing

Direct Taxation

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Agenda

- Introduction to Transfer Pricing
- Case Studies
 - Maruti Suzuki India Pvt. Ltd.
 - LG Electronics India Pvt. Ltd.
 - Sony Ericsson Mobile Communications India Pvt. Ltd.
 - Vodafone India Services Pvt. Ltd.
 - Shell India Markets Pvt. Ltd.
 - Caren India

Definition and Concept:

- Transfer Pricing is the practice of setting prices for transactions between associated enterprises that are part of the same corporate group but located in different tax jurisdictions.
- The main concept is to ensure that these transactions are conducted at an "arm's length price", meaning the price should be comparable to what would be charged between unrelated parties in similar circumstances.



Transfer Pricing refers to pricing of goods, services, or intangibles transferred between related entities, such as subsidiaries or divisions, within a multinational corporation. It covers the terms and conditions under which these internal transactions are carried out

Importance in International Taxation:

01



Tax Avoidance

Ensures transactions between related entities reflect fair market value to prevent profit shifting to low-tax jurisdictions.

02



Tax Base Protection

Safeguards a country's tax revenue by ensuring profits are taxed where economic activities occur.

03



Compliance

Aligns with global guidelines to standardize practices and prevent double taxation or non-taxation.

04



Profit Allocation

Ensures profits are properly distributed among jurisdictions based on actual economic contributions

05



Documentation & Reporting

Companies must maintain records to prove compliance with local transfer pricing laws.

Why is Transfer Pricing Important?

Avoiding Profit Shifting

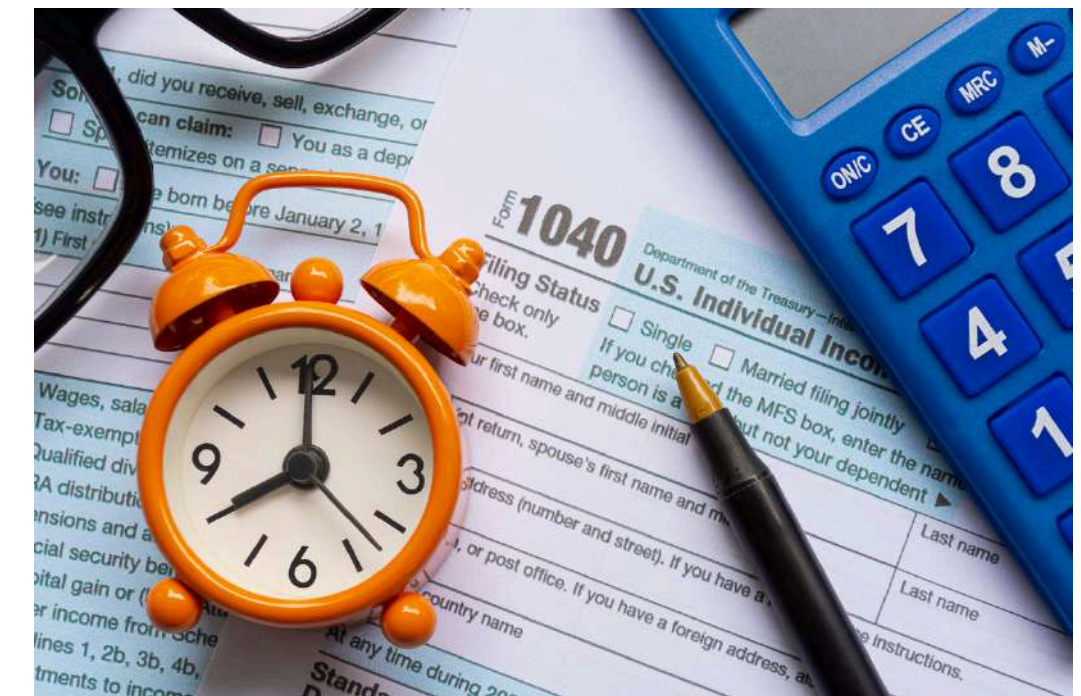
Transfer pricing prevents multinational corporations from shifting profits to low-tax jurisdictions by ensuring that intercompany transactions are priced at fair market value, reducing opportunities for tax avoidance.

Ensuring Fair Tax Allocation

It ensures that profits are appropriately allocated to the countries where the actual economic activities occur, so each jurisdiction receives its fair share of taxes based on local contributions.

Compliance with Tax Authorities

Proper transfer pricing helps businesses comply with international tax laws and regulations, minimizing disputes and avoiding penalties from tax authorities.



History of Transfer Pricing in India:

2001

Transfer pricing regulations introduced under Sections 92 to 92F of the Income Tax Act, 1961, requiring transactions between related entities to follow the arm's length principle.

2012

Safe Harbor Rules introduced, offering predefined margins for certain industries to reduce litigation and provide clarity.

2013

Advance Pricing Agreement (APA) program launched, allowing MNCs to agree in advance with tax authorities on transfer pricing methods and terms.

2015

India adopted OECD's BEPS Action Plan, aligning with global standards to address base erosion and profit shifting.

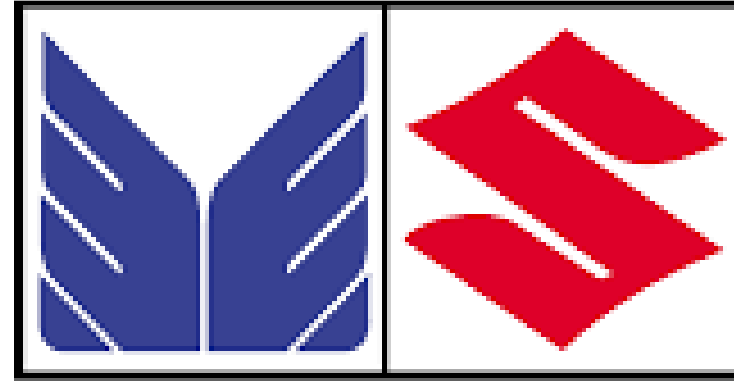
History of Transfer Pricing in India:

2017

Implementation of country-by-country (CbC) reporting and master file requirements, enhancing transparency and disclosure of global profit allocation.

Present

Implementation of country-by-country (CbC) reporting and master file requirements, enhancing transparency and disclosure of global profit allocation.



**MARUTI
SUZUKI**

Maruti Suzuki India Ltd.

- Transfer Pricing Dispute



Background

Maruti Suzuki India Ltd. (MSIL), a leading car manufacturer in India, was involved in a high-profile transfer pricing dispute with Indian tax authorities. The case revolved around royalty payments made by MSIL to its Japanese parent company, Suzuki Motor Corporation, for using “Suzuki” brand name & technology.

Issue:

The Indian tax authorities questioned arm's length nature of royalty payments made by MSIL to Suzuki, alleging that these payments were inflated & not reflective of market value. The authorities argued that such payments resulted in profit shifting to Japan and reduced the taxable income in India.



Tax Authority's View



High Royalties

The authorities contended that MSIL was bearing excessive royalty costs that were not in proportion to the benefits derived, thus impacting India's tax base.



Brand Ownership

It was argued that the brand "Maruti" itself was well-known in India and didn't justify the high royalties paid for the "Suzuki" brand.

Outcome

The case led to prolonged litigation in Indian courts and tax tribunals. After detailed hearings and reviews of transfer pricing methodologies, the courts ruled in favor of MSIL, accepting that the royalty payments were justified and in line with the arm's length principle.



Significance:

This case highlighted the complexities of intangible asset valuation, such as brand and technology, in transfer pricing.

It also underscored the challenges in determining what constitutes a fair royalty payment between related parties.

The Maruti Suzuki case became a landmark in Indian transfer pricing litigation, influencing how similar cases were handled in the future. It also stressed the importance of thorough documentation and economic analysis in transfer pricing compliance.



LG Electronics India Pvt. Ltd.

- Transfer Pricing Dispute



Background

In this case, Indian subsidiary of LG Electronics, a South Korean multinational, was involved in a dispute with Indian tax authorities. The issue centered around excessive advertising, marketing, & promotional (AMP) expenses incurred by LG India & whether these expenses benefited its parent company, LG Electronics Korea, resulting in profit shifting.

Issue:

IT authorities argued that LG India was spending a disproportionately high amount on AMP activities to promote "LG" brand in India, which belonged to parent company. The authorities claimed that this benefited parent company by increasing brand value in Indian market, & thus LG India should have been compensated for this brand-building activity.



Tax Authority's View



High Expense

- The tax authorities contended that LG India's AMP expenses were far higher than what an independent company would spend for its own marketing purposes.



Compensatory Adjustment

- They argued that these expenses were indirectly promoting the parent company's brand, and therefore, a portion of the expenses should be treated as a "service" provided to the parent company.
- The authorities demanded that LG India charge its parent company a compensatory adjustment for brand promotion.

Company's Defense



Arm's Length Principle

- LG India argued that the AMP expenses were incurred as part of routine business operations to promote its products in India, and not specifically to promote the LG brand for the benefit of the parent company.



Technology

- The company maintained that the expenses were legitimate and in line with industry standards for marketing its products locally.

Outcome

Income Tax Appellate Tribunal (ITAT) ruled in favor of Indian tax authorities. The tribunal held that LG India was, in fact, incurring excessive AMP expenses that promoted global LG brand, benefiting parent company. As a result, tribunal concluded that LG India should have been compensated by parent company for this promotional activity, leading to a transfer pricing adjustment.



Significance:

The LG Electronics case is a landmark ruling in India's transfer pricing landscape, particularly concerning the treatment of AMP expenses.

The case set a precedent for similar disputes involving other multinational corporations operating in India, especially regarding marketing and branding costs that benefit the global parent company.

This ruling reinforced tax authorities' position that MNC subsidiaries must be compensated for brand-building activities undertaken for benefit of their foreign parent companies, ensuring that profits are appropriately taxed in India.



Sony Ericsson Mobile Communications India Pvt. Ltd.

- Transfer Pricing Dispute



Background

Sony Ericsson Mobile Communications India Pvt. Ltd., Indian subsidiary of global electronics giant Sony, was involved in dispute with IT authorities over Advertising, Marketing, & Promotion (AMP) expenses. This case followed precedent set by LG Electronics case, and it revolved around whether Indian subsidiary's excessive AMP spending benefited foreign parent company & warranted a transfer pricing adjustment

Issue:

IT authorities argued that Sony Ericsson India was incurring high AMP expenses to promote "Sony" brand in India, which belonged to its parent company. The authorities maintained that these expenses benefited parent company's global brand value, & Indian subsidiary should have been compensated by parent for this brand promotion activity.



Tax Authority's View



High Expense

- The tax authorities asserted that Sony Ericsson India spent excessively on AMP activities compared to industry benchmarks and claimed that these expenses should be considered a service provided to the parent company.



Compensatory Adjustment

- They argued that these AMP expenses were not just for promoting products in India, but also for building the Sony brand value, thus justifying a transfer pricing adjustment.

Company's Defense



Arm's Length Principle

- Sony Ericsson India contended that the AMP expenses were part of its regular business operations and were incurred solely to market its products within India.



Technology

- The company maintained that these expenses were not intended to promote the global Sony brand and therefore should not result in a transfer pricing adjustment.

Outcome

The Income Tax Appellate Tribunal (ITAT) ruled in favor of tax authorities, affirming that Sony Ericsson India's excessive AMP expenses indirectly promoted global brand owned by parent company. The ITAT concluded that these expenses benefited parent company and, thus, required a transfer pricing adjustment. The tribunal instructed that part of the AMP expenses should be treated as an international transaction requiring parent company to compensate Indian subsidiary.



Significance:

The Sony Ericsson case reinforced the earlier LG Electronics decision regarding the treatment of AMP expenses in transfer pricing cases.

It established a broader interpretation of AMP expenses as international transactions, ensuring that when Indian subsidiaries incur excessive marketing expenses that benefit the global parent's brand, they must be appropriately compensated.

This case further strengthened the Indian tax authorities' stance on scrutinizing high AMP expenses for potential transfer pricing adjustments and became a benchmark for several similar cases involving other multinationals operating in India.



Vodafone India Services Pvt. Ltd.

- Transfer Pricing Dispute



Background

Vodafone India Services Pvt. Ltd., a subsidiary of global telecom giant Vodafone, was involved in a significant transfer pricing dispute with IT authorities. The case revolved around issuance of shares by Vodafone India to its parent company, Vodafone Group, and whether this transaction had transfer pricing implications.

Issue:

In 2007-08, Vodafone India issued shares to its parent company, Vodafone Group, at face value. IT authorities claimed that shares were undervalued, alleging that issuance was not at an ALP. They argued that difference between FMV of shares & issue price should be treated as a transfer pricing adjustment, & that undervalued portion was effectively an "income" that required taxation.



Tax Authority's View



High Expense

- The tax authorities contended that the issuance of shares below FMV constituted an international transaction, leading to undervaluation and profit shifting.



Compensatory Adjustment

- They argued that the difference between the FMV and the price at which shares were issued was a deemed loan to the parent company, subject to transfer pricing regulations and taxation.

Company's Defense



Arm's Length Principle

- Vodafone India argued that the issuance of shares is a capital transaction and not subject to transfer pricing rules, as it does not involve income or taxable gains.



Technology

- The company contended that transfer pricing provisions are intended for the pricing of goods, services, or intangibles, and should not apply to capital financing transactions like share issuances.

Outcome

The case went through various levels of litigation, and in 2014, the Bombay High Court ruled in favor of Vodafone India, dismissing the tax authorities' argument. The court held that share issuances are capital transactions and not subject to transfer pricing adjustments, as they do not generate income.

The court ruled that transfer pricing provisions cannot be invoked for transactions involving capital receipts or investments, thereby rejecting the tax authority's claim that Vodafone should be taxed for the undervaluation of shares.



Significance:

Vodafone India case is a landmark ruling that clarified scope of transfer pricing regulations in India. It established that capital financing transactions, like issuance of shares, are not subject to transfer pricing rules since they do not involve generation of taxable income.

The case was pivotal in providing clarity to multinational corporations regarding the applicability of transfer pricing laws to capital transactions & helped set limits on tax authorities' interpretation of international transactions.

It also led to broader discussions around the treatment of foreign investments under Indian tax laws and transfer pricing.



Shell India Markets Pvt. Ltd.

- Transfer Pricing Dispute



Background

Shell India Markets Pvt. Ltd., a subsidiary of Royal Dutch Shell, became embroiled in a high-profile transfer pricing dispute with Indian tax authorities in 2013. Case centered around valuation of shares issued by Shell India to its parent company in 2009. This case was similar to Vodafone India case, as it also involved transfer pricing treatment of capital transactions.

Issue:

Shell India issued shares to its parent company at face value. However, Indian tax authorities claimed that shares were undervalued & should have been issued at a higher FMV. The tax authorities argued that the difference between FMV and issue price amounted to a transfer pricing adjustment, & they sought to impose a tax on this supposed under-valuation, treating it as income.



Tax Authority's View



High Expense

- The authorities contended that the share issuance was an international transaction subject to transfer pricing regulations, and the under-valuation of shares should be taxed as income.



Compensatory Adjustment

- They sought to add over ₹15,000 crores (~ \$2.5 billion) to Shell India's income as a transfer pricing adjustment based on the alleged undervaluation.

Company's Defense



Arm's Length Principle

- Shell India argued that the issuance of shares is a capital transaction and not subject to transfer pricing rules, as it does not generate income.



Technology

- The company asserted that transfer pricing regulations apply to the pricing of goods, services, or intangibles, and cannot be invoked for capital financing transactions like share issuances.

Outcome

In 2014, the Bombay High Court ruled in favor of Shell India, stating that capital transactions like share issuances are not subject to transfer pricing rules. The court held that since the issuance of shares does not result in income generation, it falls outside the purview of transfer pricing laws.

- The court rejected the tax authorities' claim of treating the alleged undervaluation as taxable income, providing Shell India with a major victory.
- Following this ruling, similar tax demands on other multinationals related to share issuance disputes were also dropped.



Significance:

The Shell India case reaffirmed the legal precedent set in the Vodafone case, where the court ruled that capital transactions are not subject to transfer pricing adjustments.

This ruling provided clarity to multinational corporations regarding the limits of transfer pricing regulations, especially in cases involving capital investments and share issuances.

The case marked a turning point in India's approach to tax disputes involving MNCs, discouraging aggressive interpretations of transfer pricing laws by tax authorities in capital-related matters.



Starbucks India Tata Starbucks Pvt. Ltd.

- Transfer Pricing Dispute



Background

Tata Starbucks Pvt. Ltd., a joint venture between Tata Group & Starbucks Corporation, faced a transfer pricing dispute with Indian tax authorities regarding royalty payments made by Indian entity to Starbucks for use of Starbucks brand & operational expertise.

Issue:

Indian tax authorities argued that royalty payments made by Tata Starbucks to Starbucks Corporation were excessive & not aligned with arm's length principle. Authorities claimed that Starbucks India was shifting profits to its parent company by inflating these royalty payments, thereby reducing its taxable income in India.



Tax Authority's View



High Expense

- The authorities contended that the royalty payments were disproportionately high compared to what an independent entity would have paid under similar circumstances, leading to profit shifting and tax base erosion in India.



Compensatory Adjustment

- They demanded a transfer pricing adjustment, arguing that the royalties should be lowered to reflect an arm's length price.

Company's Defense



Arm's Length Principle

- Tata Starbucks defended the royalty payments, asserting that they were in line with international standards and justified given the benefits derived from Starbucks' global brand and operational expertise.



Technology

- The company maintained that the royalties reflected the true value of the Starbucks brand, which contributed significantly to its business success in India.

Outcome

In this case, Indian tax authorities won the initial round of the dispute. They determined that the royalty payments were indeed excessive and required a transfer pricing adjustment. This led to an increase in the taxable income of Tata Starbucks in India, as the authorities reduced the allowable deduction for royalty payments.



Significance:

- This case was significant because it highlighted the Indian tax authorities' focus on scrutinizing royalty and intellectual property payments between multinational corporations and their subsidiaries.
- The ruling emphasized the importance of ensuring that such payments are in line with the arm's length principle, preventing MNCs from using high royalty payments to shift profits out of India.
- The Starbucks India case became a reference point for other MNCs operating in India, particularly those in sectors where brand value and intellectual property play a key role in business operations.



Cairn India

- Transfer Pricing Dispute



Energy for India

Background

Cairn India, an oil & gas exploration & production company, became embroiled in major transfer pricing dispute with tax authorities over a alleged underpricing of a corporate reorganization transaction that took place in 2006. The transaction involved transfer of shares of Cairn India Holdings to its parent company, Cairn Energy Plc (UK).

Issue:

Tax authorities claimed that Cairn India transferred its share to its UK parent company at an undervalued price, which is transfer pricing violation. They argued that transaction was not at ALP, resulting in shifting of profits to parent company & reducing tax liability in India.

Authorities raised a demand of over ₹10000 crore (approx. \$1.6 billion) in tax, interest, & penalty, based on valuation difference they alleged between actual transaction price & FMV of shares.



Tax Authority's View



High Expense

- The authorities asserted that the transfer of shares was part of an international transaction between related parties and thus fell under transfer pricing regulations.



Compensatory Adjustment

- They argued that Cairn India failed to value the shares at arm's length, leading to significant tax avoidance.

Company's Defense



Arm's Length Principle

- Cairn India maintained that the share transfer was part of a legitimate corporate reorganization and that it had followed all applicable laws and guidelines.



Technology

- The company argued that the transaction was not taxable under Indian law and denied any under-pricing or profit shifting.

Outcome

This case went on for several years, and in 2016, Income Tax Department won an interim victory when Income Tax Appellate Tribunal (ITAT) ruled in favor of tax authorities, agreeing that transaction was subject to transfer pricing rules. However, Cairn India continued to challenge tax demand, escalating matter to international arbitration.

In 2020, Permanent Court of Arbitration in The Hague ruled in favor of Cairn Energy (UK), stating that India's retrospective tax demand was unfair under India-UK Bilateral Investment Treaty (BIT). Tribunal ordered India to pay damages to Cairn, though Indian govt has been contesting ruling.



Significance:

- Cairn India case is one of the most prominent transfer pricing and retrospective tax disputes in India. It highlighted complexities surrounding retrospective taxation and transfer pricing rules in the context of corporate reorganizations.
- The case has significant implications for foreign investors in India, especially in how transfer pricing disputes can be prolonged and lead to international arbitration.
- It underscored the need for clear, transparent guidelines for international transactions and corporate reorganizations to avoid lengthy disputes.





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THANK YOU

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