Transfer Pricing and Business Restructurings

Streamlining all the way

India

Mukesh Butani, Partner BMR & Associates

2. Tax consequences of various models

2.1. Characterization of manufacturing entities

A contract manufacturing arrangement is similar to a toll manufacturing operation. Under a contract manufacturing arrangement, the distributor/principal entity enters into a contract with the contract manufacturing company, to manufacture products according to the specifications under a buy-sell arrangement. The risks borne may be marginally more than those borne by a toll manufacturer, but a contract manufacturer is essentially an entity which assumes limited risk.

The returns earned by contract manufacturers are essentially based on a cost-plus return on the manufacturing costs incurred by the contract manufacturer.

Manufacturing can range from a simple toll manufacturer undertaking limited functions and risks, to the more complex, integrated fully-fledged manufacturer undertaking all related functions.

2.2. Principal manufacturer versus contract or toll manufacturer

A *principal manufacturer* will assume a wider range of functions and risks. It often undertakes activities such as production scheduling and R&D, and owns the intangibles associated with the products it manufactures. Following on the example above, the returns made by a principal manufacturer will be higher and commensurate with the increased risks it bears.

………

Sale or transfer of tangible/intangible property. Restructuring arrangements that entail a shifting of assets (tangible or intangible) in accordance with reallocation of functions and risks, usually result in a taxable transaction. Generally, when an Indian principal manufacturer is being restructured as a contract or toll manufacturer, such restructuring would involve shifting of the intangible property (e.g. know how and patents) owned by the manufacturer. This shift of intangible property could lead to a taxable transaction in the hands of the manufacturer.

Re-allocation of functions and risks. If a multinational enterprise (MNE) chooses to restructure an Indian principal manufacturer along the lines of a contract manufacturer, it must ensure that the form of the arrangement reflects the substance also. For example if the Indian contract manufacturer undertakes significant risks and responsibilities, the tax authorities may challenge the cost-plus return to the contract manufacture function and attempt to attribute higher profits to Indian operations.

Permanent establishment exposure. If an MNE exercises control over the toll or contract manufacturing operations in India, the tax authorities may try to establish that a permanent establishment (PE) exists in India. This risk is normally greater where the range of economically significant functions assumed by the non-resident company is higher and more closely connected with the day-to-day operations of the manufacturing entity. However, Indian courts have recently taken the position that if an MNE remunerates the entity resulting in creation of a PE on an arm's length basis, no further profits may be attributed to the MNE.

……………………………..

3. Transfer pricing details

Drawing from the OECD Guidelines, Indian transfer pricing regulations are comprehensive and clearly establish the principles of transfer pricing and elaborate on the meaning of international transactions, associated enterprises and the conditions to be satisfied thereof. In line with the OECD, Indian transfer pricing regulations list the methods that may be used in the determination of the arm's length price, and requires the use of the most appropriate methodology from among the following:

- comparable uncontrolled price method;
- resale price method;
- cost-plus method;
- profit split method; and
- transactional net margin method.

Unlike the OECD, Indian transfer pricing regulations do not prescribe a hierarchy of methods. The arm's length price is taken to be the arithmetic mean of comparable prices, and a variation of 5% from such arm's length price is permissible.

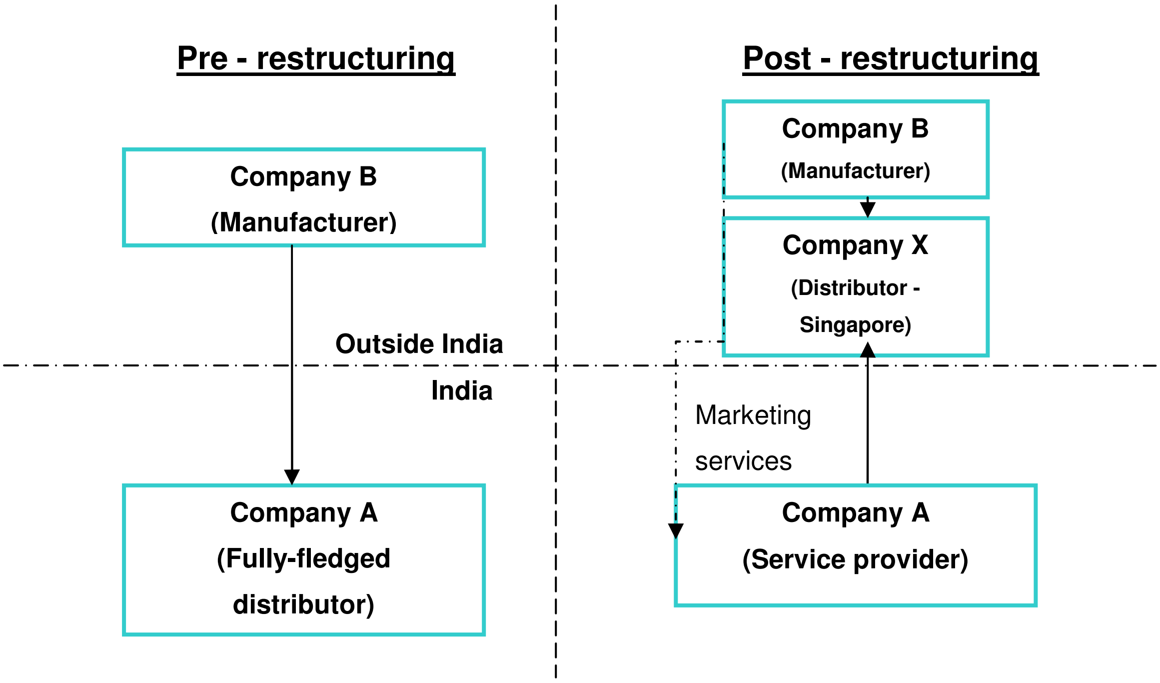
While India's transfer pricing framework is fairly robust, it continues to remain at a nascent stage with few precedents on issues such as implications of business restructuring and transfer pricing of intangibles. However, with four rounds of audits completed, the fifth round underway and several Appellate and Tribunal proceedings in progress, there seems to be increasing clarity regarding interpretation of the legislation. Moreover, there is increasing facilitation in establishment of principles based on practical and economic rationales drawn from business realities and circumstances.

3.1. Issues arising upon restructuring in case of stopping activities and post-restructuring issues

While there is little jurisprudence concerning cases of business restructuring and the transfer pricing implications thereof, there has been increased questioning by the tax authorities on various issues arising as a result of restructuring. The rationale here is that if, as a consequence of restructuring, the entity residing in a particular jurisdiction is stripped off its risks and functions, it should be compensated for the loss of income in that same jurisdiction. In such an event, what is important is that any business restructuring that a company undergoes should take into account such notional adjustments in arriving at the total cost of restructuring.

Stopping activities essentially entails closing down a particular line of business or activities in the course of restructuring. As regards India, the regulations do not require any form of compensation to be paid for such stoppage of activities, i.e. no form of exit taxation is imposed.

The issues arising can be illustrated by way of an example: Company *A* operates as a fully-fledged distributor for an overseas affiliated manufacturer, Company *B*, and earns revenue from reselling televisions.



……………………

5. Anti-avoidance provisions

While there are certain provisions under the ITA aimed at curbing specific transactions undertaken with a view to avoid tax, there is no general anti-avoidance legislation in India. The term "tax avoidance" is not been defined in either the ITA or Indian income tax treaties. Consequently, one must rely on judicial interpretation of the term to understand its true meaning. Courts have generally viewed "tax avoidance" as a mechanism to apply to transactions which are structured within the legal framework in order to minimize or avoid taxes. Tax avoidance is a term used in contrast to "tax evasion", which refers to transactions that are either beyond the boundaries of law or are entered into only on paper in order to avoid or reduce tax liabilities. The former is usually tolerated by courts, while the latter is frowned upon.