

MANAGING GLOBAL SUPPLY CHAIN: TRANSFER PRICING ISSUES AND SOLUTIONS

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ABSTRACT

World trade of goods and services is based upon the global supply chain and logistics management, and its flow is determined by the drivers of supply chain management. For a company to be successful in the new millennium where a paradigm shift has taken place it becomes necessary that its supply chain strategy gets fit with its competitive strategy so as to strike an appropriate balance between the supply chain's efficiency and responsiveness. One of the supply chain management's drivers, to achieve this fit is known as "Pricing". In the context of global supply chain management, Transfer Pricing, with its components such as Arm's Length Pricing (ALP), Advance Pricing Agreement (APA), Safe Harbour Rules (SHRs), etc. play a very important role and, therefore, in this paper an attempt has been made to explain issues relating to transfer pricing vis-à-vis solution for the same, so that MNEs may operate and supply their tangibles and intangibles to their related companies globally without having any disputes / litigations with a the taxation authorities.

Keywords: *Global supply chain management, Transfer Pricing, Abuse of transfer Pricing, Arm's length pricing (ALP), Abuse of Transfer Pricing, Advance Pricing Agreement (APA), Safe Harbour Rules (SHRs), Mutual Agreement Procedure (MAP).*

INTRODUCTION

World trade of goods and services is based upon the global supply chain and logistics management, and its flow is determined by the drivers of supply chain management. For a company to be successful in the new millennium where a paradigm shift has taken place it becomes necessary that its supply chain strategy gets fit with its competitive strategy so as to strike an appropriate balance between the supply chain's efficiency and responsiveness. One of the supply chain management's drivers, to achieve this fit is known as "Pricing". In the context of global supply chain management, Transfer Pricing, with its components such as Arm's Length Pricing (ALP), Advance Pricing Agreement (APA), Safe Harbour Rules (SHRs), etc. play a very important role and, therefore, in this paper an attempt has been made to explain issues relating to transfer pricing vis-à-vis solution for the same, so that MNEs may operate and supply their tangibles and intangibles to their related companies globally without having any disputes / litigations with a the taxation authorities.

GLOBAL SUPPLY MANAGEMENT IN NEW MILLENNIUM

In the new millennium, world trade, which essentially is based on supplying of goods and services, is expanding at an exponential rate primarily because of globalization with the increasing focus on integrations of more and more national economies with the global economy. New and sophisticated technologies determining the supply chain performance are advancing fast and becoming the driving force for such an increasing integration. As a result, the customers across the globe are demanding more value for money in terms of price, quality, service and quick deliveries. The companies across the world are, therefore, experiencing increasing competitive pressure not only for growth but even for their survival.

This changed scenario, i.e. a paradigm shift, has forced the companies across the globe to re-evaluate their business processes not only for getting the economies of scale in manufacturing operations but also to re-examine the way deliveries of products and services to their customers are made. Severe competition and unending proliferation of product varieties coupled with value added logistics services put together have made markets more volatile than ever before. Thus, it has become necessary for business organizations to manage their global supply chain by achieving the strategic fit of supply chain strategies with that of competitive strategies.

STRATEGIC FIT

- The strategic fit requires that a company's supply chain has to achieve the balance between responsiveness and efficiency that best supports the needs of the company's competitive strategy.For this company has to first identify its competitive strategy and that too for its different segment of customers (Chopra et.al, 2013)
- To understand how a company can, improve its supply chain performance in terms of responsiveness and efficiency, it must examine the following three logistical and three cross-functional drivers of supply chain performance (For details see Chopra et.al. 2013):

Logistical Drivers: Facilities (F), inventory (I), transportation (T) ----- FIT

Cross Functional Drivers: information (I), sourcing (S), and pricing (P) ----- ISP

These drivers "FIT-ISP" interact with each other to determine the supply chain's performance. By structuring / restructuring these six drivers simultaneously a Firm should design a supply chain that can meet two divergent needs of responsiveness (high price of delivering goods) and efficiency (low price of delivering goods) to meet the needs to different types of customer segments so as to get a near perfect strategic fit. An excellent example to achieve the strategic fit of Wall Mart has been given by Chopra, et.at. (2013).

PRICING

Amongst these drivers, this paper is now dedicated to one of the six drivers namely "Pricing".

PRICING AND SUPPLY CHAIN MANAGEMENT

Pricing plays very important role in supply chain management. It is the process by which a firm decides how much to charge customers for its goods and services and many a times is also associated with the value-added logistics services. It affects the customer segments that choose to buy the product, as well as the customer's expectations.

This directly affects the supply chain in terms of the level of responsiveness required as well as the demand profile that the supply chain attempts to serve. Pricing is also a kind of tool or a lever that may be used to match supply and demand.

Pricing, however, has different components and for that there is a matrix which may be used to set the capabilities of supply chain so as to achieve the strategic fit. These components may be divided into the two categories. In the first category, components which in general, are applicable for all firms and in the second category includes additional components which are applicable for the supply chain related issues pertaining to the affiliated or associated enterprises – more particularly for the international companies which are having international transactions of supplying goods and services to their related companies. These two categories of components are listed in the table 1

Table 1: The components of "Pricing Driver" to set the capabilities of SCM to achieve strategic fit.

| Category 1 General components applicable for all firms | Category 2 Additional Components for related firms in global context |
|--|---|
| <ol style="list-style-type: none"> Economies of Scale Everyday Low Pricing Versus High-Low Pricing Fixed-Price Versus Menu Pricing INCOTERMS | <ol style="list-style-type: none"> Transfer Pricing Abuse of Transfer Pricing Arms' Length Pricing (ALP) Advance Pricing Agreements (APA) Mutual Agreement Procedure (MAP) Safe Harbour Rules (SHR), etc. |

One of the important point that needs to be noted that while designing the supply chain strategy to achieve the

strategic fit, in the second category more attention is given to the efficiency than responsiveness because of the existing relations between supplier and receiver of the products or services. In such a case, the receiver indeed is an internal customer of the supplying company, therefore, supply chain uncertainties may be controlled largely by the parents company. This provides more opportunities to increase the efficiency of the supply chain without effecting the customer service i.e. the responsiveness.

As the objective of this paper is discuss the issues related to global supply chain in context of international transfer pricing (ITP), the paper now will be dealing with the category 2 components of pricing driver as given in table 1. In addition to the components given in category 1, the international firms, such as MNCs, TNCs, Global companies or in a broader sense MNEs very often use the transfer pricing as a tools for maximizing the global profits while charging the manipulated prices for supplies made of goods and services (tangibles and intangibles) to their related firms. It is also worth to note that the concept of transfer pricing (TP) and its application are applicable for both national and international transactions and most of the nations have a different set of rules and regulations for domestic transfer pricing and international transfer pricing. However, in context of Global Supply Chain Management – This concept in general is known as International Transfer Pricing, which is used as tool or lever to maximize the global profit of an international enterprise.

TRANSFER PRICING

In taxation and accounting, transfer pricing refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control. According to the Indian Income-tax Act, 1961, income arising from such transactions must be computed using the arm's length price principle, that is, the amount payable if the trading companies were unrelated or uncontrolled. Transfer pricing provisions are applicable on international transactions and specified domestic transactions between associated enterprises (Sira, 2018). In case of international transaction, to be more specific, transfer pricing (TP) may be called as international transfer pricing (ITP) is an amount or the value charged between the associated companies which are located in different jurisdiction across the globe. As stated by Mishra (2019) such "transactions between related companies may occur in different situations between independent companies. Transfer pricing is a term used to describe the cost of services, including cross-border, inter-group transactions of goods, immovable property or financial services".

Thus, as stated by Sikarwar (2012) Transfer Pricing "refers to the pricing of assets, tangible and intangible, services, and funds transferred within an organization in a cross-border transactions". These are 'Intra-firm' prices which are administered and not the market prices representing new values appropriated by one firm from another. According to Kumar (1985) transfer price is, thus, a price at which 'intra-firm' (i.e. two affiliates of a MNE) trade takes place.

Symbolically, as per UN (1965), transfer price may be expressed as:

$$Pa - Pw / Pw \times 100$$

Where, Pa is the actual import price or export price, as shown on the invoice and Pw is the reference world price used for comparison. This formula indeed gives the degree of over pricing and underpricing.

TRANSFER PRICING ABUSE

With the prime motive of maximizing global profit, several MNEs have been using transfer pricing to their benefits by evading the taxes in countries where they are operating. In fact, the abuse of international transfer pricing is not a new phenomenon and the numerous evidences can be seen in the literature (Chandrashekhar & Purakayastha, 1982; Chugan, 1993, 1999, 2007, 2007(a) and 2008; Deo, 1975, 1977 and 1986; Krishna, 1984; Kumar, 1984; Lall 1973 and 1979; Mann, 1982; Peter; 2006; Ramanujam, 2001; REGTPG, 2002; Subrahmanian & Pillai, 1976; Vaitos, 1974; Venu, 1983). When this practice is followed, it is known as the abuse of transfer pricing and that becomes a major issue of dispute between the taxation authority and the MNEs the world over. Even today, in many parts of the world, taxation authorities have been finding new cases for abuse of transfer pricing resulting in disputes and litigations between the MNEs and taxation authorities. On the one side taxation authorities are to maximize their revenue by scrutinizing the MNEs transactions and on the other side the MNEs may make all attempts to maximize their global profits by not using the arm's length pricing (ALP) principle for their pricing transactions with their affiliated / associated enterprises (AEs)

ARM'S LENGTH PRICING (ALP)

As stated by Mishra (2019) "the prices of such transactions between associated enterprises (AEs) should, however, for tax purposes, be in conformity with those which would be charged between independent enterprises, usually, referred to as arm's length pricing. Arm's length simply means 'at a distance, not on familiar or friendly terms'. Arm's length pricing (ALP) is an international standard that compares the transfer prices charged between associated enterprises with the prices carried out between independent entities."

The OECD manual states that "ALP valuation principle is commonly applied to commercial and financial transactions between related companies. It says that transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest. According to Taxman (2021) "the concept of Arm's length derives its meaning from the independent relation shared between independent parties. Unlike business transactions between related parties, the transactions between unrelated parties are done at an open market price and accordingly, Arm's Length Price (ALP) demonstrates the price that should have been charged between related parties had those parties were not related to each other".

RESULTANT ISSUES: TRANSFER PRICING DISPUTES

Due to abuse of transfer pricing the disputes between the taxation authorities and multinational enterprising are on increase and impose a major disruptions in smooth operations of the global supply chain because a large part of global trade is carried out amongst the multinationals with their related enterprises. "Around 60% of the global trade transactions that take place are carried out in a corporate groups (Soan, 2014)". So, if such transaction are not based on the principle of ALP, certainly they will generate disputes with the taxation authorities under the jurisdictions they have been operating. And once the dispute has arisen its solution rests with litigation the court battles or go for mutual agreement procedure with the taxation authority.

As per OECD statistics (Martin 2019), "In 2019, the number of times that taxpayers needed to resort to the mutual agreement procedure (MAP) in a tax treaty to resolve a transfer pricing dispute increased by more than 20 percent as compared to 2018, OECD said in a release analysing the new statistics. Germany had the greatest number of new MAP cases in 2019, with 659 new cases filed, the new data revealed. This was followed by the US with 350 new filings; France with 381; and India, with 2016 new cases. The country with the largest overall MAP caseload at the end of the reporting period was Germany, with 1,242 tax disputes pending. This was followed by the US, which had 1,022 cases; by India, with 951; by France with 902; and by Italy with 887. Japan's and the UK's tax authority tied for an award that recognized the shortest time taken to close transfer pricing cases among those countries that closed more than 50 transfer pricing cases in 2019. Japan and the UK both averaged 21 months to close these cases. This was followed by Switzerland, which closed transfer pricing cases, on average, in 23 months".

Moreover, due to pandemic situation, governments the world over are under pressure to generate more revenues their taxation authorities are more vigilant to detect such abuses of transfer pricing and to generate demands for tax collection from the multinational companies. According to Ludwig (2020), the Partner Grant Thornton Germany, "The fiscal deficits within many countries mean that tax authorities will be keen to maximise tax take and reluctant to share this with other jurisdictions. Transfer pricing scrutiny and the potential for double taxation and disputes have increased as a result. This makes it even more important to ensure that transfer pricing approaches are watertight." Thus the issues are:

- On the one side taxation authorities are to maximize their revenue by scrutinizing the MNEs transactions and on the other side the MNEs maximize their global profits by not using the arm's length principle (ALP) for their firms' related pricing transactions resulting in disputes and court battles and
- The lack of transparency in the TP Rules, because of which MNEs would not prefer to invest and supply their tangible and intangible assets to the countries where there are more chances of disputes.
- In the absence of total transparency with respect to TP rules, there will be more and more disputes providing very large scope of litigations, which ultimately not only erode the confidence of overseas investors but also becomes a major hindrance in attraction foreign investment in the country.

SOLUTIONS

To resolve these issues and smooth operations of global supply chain in the larger interest of the MNEs as also to the national taxation authorities following steps may provide appropriate solutions:

1. The introduction of the TP Rules and their modification and updating them in line with the OECD guidelines

2. Adoption of new concepts such as Advance Pricing Arrangement (APA) and the Safe Harbour rules (SHRs), etc.
3. MNEs to strictly follow the ALP system with full evidences for supplying tangibles and intangibles to their associates
4. Create awareness of the above and develop required manpower – skilled professionals to handle such issues.

INDIAN SCENARIO

- Transfer pricing rules in India were introduced in the year 2001 and were effectively implemented during 2003.
- Tedious documentation, muddled and complicated procedures, and rigorous penalties and so many disputes have attracted courtroom battles between the tax authority and the tax payers.
- This has warranted government of India to make the transfer pricing legislation more transparent including globally established practices as prescribed by the OECD.
- The introduction of the TP Rules and their modification and updating in line with the OECD guidelines and adoption of new concepts such as Advance Pricing Arrangement (APA) and the Safe Harbour Rules (SHR) are the right steps in this direction and have already been included in the Indian TP regulations.

ADVANCE PRICING AGREEMENT (APA)

APA is a deal that has been negotiated between the taxpayers and the taxation authority of a country through which an agreement in advance is signed by both parties agreeing for the method to be used to determine the transfer pricing of the transactions to take place between the MNCs, foreign parent, and its associate, subsidiary, affiliate or related parties, etc. so that there are no disputes at the later stage. Under this mechanism the methods for determining the transfer pricing for inter-company transactions are set well in advance which help avoid post transaction disputes and provide multinational companies certainty about their tax liabilities.

“These APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the “covered transactions.” APAs provide greater certainty for the taxpayer on the taxation of cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. Many countries have introduced APA procedures in their domestic laws though having different legal forms. For example, in certain countries an APA may be a legally binding engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer” (OECD, 2017).

APAs are of two categories. One - Unilateral APAs (involving one country) - an agreement between a taxpayer and the tax administration of the country where it is subject to taxation. And second, the Bilateral (involving two countries) & Multilateral APAs (involving more than two countries). “A bilateral or multilateral APA is entered into between the taxpayer, the tax administration of the country where it is subject to taxation and one or more foreign tax administrations (PWC, 2011). It is an arrangement between a business (MNC or its subsidiary i.e. the tax payer), the Tax Office in host country and one or more foreign tax authorities. Bilateral or Multilateral APA if applicable is considered a better option and preferable because it may give full solution with a very little or no scope for future disputes. In India, In India, the Finance Act 2012 introduced the Advance Pricing Agreement Rules (APA) programme to be effective from July 1, 2012 and rules have been updated with the inclusion of provisions on roll back, range base concept of ALP, use of multi year’ data, etc. which has made the APA Programme very attractive.

SAFE HARBOUR RULES (SHR)

Internationally, Safe Harbour and Advance Pricing Arrangement (APA) are emerging as the two most efficient ways of reducing litigation in the area of transfer pricing, which is developing as the most important taxation subject among the chief executives and tax authorities (Chugan 2010). The literal meaning of the term “safe harbour” is “safe haven or a place which provides security or safety”. But in taxation, it means that the results of the taxpayers who fulfil the required conditions are accepted by the taxation authority and they are exempt from detailed scrutiny. The rules under this system provides certainty to multinational enterprises, and they may supply tangible and intangibles to their global associates without fearing any disputes and litigations and thus, smoothens the global supply chain. Thus, this system is aimed to strength the confidence of overseas investors. In India, SHRs were introduced in 2013 and have been updated in 2017.

Section 92CB of the Act defines Safe Harbour’s terminology as "under such circumstances the income-tax authorities will accept the transfer price declared by the assessment." The rule provides a minimum operating profit

margin in relation to operating expenses that a taxpayer is expected to earn for certain categories of international transactions. (Sharma, 2014). Under these rules taxation authority (income tax department), under certain situations, will not raise any doubt or question on the pricing related transactions between the multinational corporations and their related concerns namely subsidiaries for specified sectors such as information technology, IT-enabled services, knowledge process outsourcing, auto-components manufacturers, besides intra-group outbound loans and corporate guarantees.

MUTUAL AGREEMENT PROCEDURE (MAP)

Under the heading of transfer pricing dispute above some data on MAP have been given to explain how many time transfer pricing disputes are increasing and taxpayer are going through the MAP to resolve such cases. It, therefore, becomes important to explain what are MAPs and how are they different from APAs? As explained by Deloitte (2012) “MAP is a mechanism laid down in tax treaties to ensure that taxation is in accordance with the tax treaty. This can also be invoked when a tax payer suffers or is likely to suffer an adverse action during transfer pricing audit to avoid economic double taxation. On the other hand, APA can be entered into for prospective years. Tax payers with litigation history may opt to file MAP in respect of pending disputes and also opt for APA for the same transactions for the future years as an effective dispute resolution/ avoidance strategy”.

CONCLUSION

The international companies engaged in global transactions for supplying goods or services to related or associated companies, thus, may have now alternative options for managing their global supply chain by adopting a suitable component of pricing driver of SCM so as to avoid disputes and litigations with the taxation authority. In case, neither APA nor SHR, is acceptable to a MNE it has to go for ALP with strong and convincing evidences that such goods or services were supplied at the market driven prices which are acceptable to taxation authority. If, an enterprise is not sure of this, it has the option to go through APA. But APA is time consuming, involves a cumbersome procedure and its benefits depends upon the convincing and bargaining skills of the executives of company who are involved in the several rounds of negotiations and finally drafting APA with the taxation authority. SHRs on the other hand provide real-time solution. But, in general, SHRs not available for all the sectors. For example, in USA, only a “few limited safe harbours rules are available for controlled borrowing and controlled service transactions (Lexology 2019), whereas in India, these are available to a few selected sectors as mentioned in above para under the heading of SHR. Moreover, if SHRs are available, a company may not find them attractive and would prefer to go for APA because it may get more beneficial deal for the supplies made under APA. Therefore, the cost benefit approach may be analysed to decide which one is better. In any case, it extremely important for the global companies to manage their global supply chain related issues if such transactions are done with their related companies across the borders by adopting an appropriate technique for avoiding disputes and litigations for the transfer pricing.

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