

MANAGING SUPPLY CHAIN IN CONTEXT OF TRANSFER PRICING

Prof. (Dr.) Pawan Kumar Chugan

Visiting Professor, IMNU, PDEU and Gujarat University, Ahmedabad

Prof. (Dr.) Nilam Panchal

Head DPPG, B. K. School of Professional and Management Studies, Gujarat University, Ahmedabad

ABSTRACT

It is now very widely known that supply of good and services across the borders by the associated / related companies is subject to the high risk of having disputes with the taxation authorities for abuse of transfer pricing for their international operations which very often may result in litigations. Thus, managing the supply chain when it is related with transfer pricing is extremely important for the smooth conduct of business, This paper in this context, therefore, first explains the relevant concepts of supply chain operations between the associated companies with tax implications, transfer pricing, abuse of transfer pricing, Arm's Length Pricing, Advance Pricing Agreement, Safe Harbour Rules and then explains how such risk of disputes and litigations may be minimized or even eliminated by adopting a suitable legitimate techniques as per the prescribed guidelines and laws of the national and international institutions enabling MNEs to supply tangible and intangibles to their associate companies without having any issues with the taxation authorities.

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

INTRODUCTION

In the global supply chain and logistics management the concept of transfer pricing is extremely relevant because the prime objective of the Global Companies or the Multinational Enterprises (MNEs) is to maximize their global profits and for that transfer pricing is used as a tool. Pricing of goods and services, is indeed one of the most important drivers to manage the supply performance. "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 (Chugan and Panchal 2022)". Thus, there are certain linkages between the supply chain and pricing and these linkages get more complexed when there are international transactions and that too between the related, affiliated or associated enterprises (AEs) which are operating under the same management system and are subject to audit of the taxation authorities. This creates many obstacles in the smooth functioning of supply chain and quite often such transaction end up with the disputes between the taxpayers (MNEs) and taxation authorities.

SUPPLY CHAIN OPERATIONS

To understand the supply chain operations between the related companies under mechanism of transfer pricing it is necessary to first understand the two concepts viz the concept of supply chain and the concept of transfer pricing separately and then examine their linkage so as to find the solution – viz. a kind of a hedging environment or umbrella under which the MNEs may operate without having any dispute with the taxation authorities and not only do their business fearlessly but also reap the benefits of their international transactions.

Supply Chain (Scenario 1)

Supply Chain in general refers to the flow of products and services (both tangibles and intangibles) from company A to company E as shown in diagram 1:

Diagram 1: Supply Chain (Scenario 1)

A	B	C	D	E
Raw materials manufacturers	Intermediate products manufacturers	End product manufacturers	Wholesalers and Distributors	Retailers

Flow of Material



This flow of material is connected by transportation and storage activities in an integrated manner through information, proper planning and all related activities with a proper logistics mix. While doing so, supply chain and logistics management has to ensure a tradeoff between the cost and the service levels because they move in opposite direction. To do this various type of supply chain drivers are used. One of such drivers is known as Pricing.

In the above diagram 1, the parties to the supply chain viz. A, B, C, D, and are separate entities but depend on each other for the supply chain transactions and following points need be mentioned:

1. B procures raw materials and inputs from A at the negotiated prices, which are market driven prices, at the pre-set terms and conditions and whatsoever profit is made by A on supply of raw material and inputs as shown in its balance sheet and due taxes are paid to Govt.
2. B completes the necessary intermediary jobs and supply the products to C for further processing to complete the end or finished products. This sell transaction is also done at market driven negotiated prices and whatsoever profit is made by the B on this transaction is shown in its balance sheet and due taxes are paid to Govt.
3. C completes the final activities and supply finished products to D viz. wholesalers or distributors. Sale transactions are done at negotiated prices and whatsoever profits are made by C of such transaction are shown on its balance sheet and due taxes are paid to the Govt.
4. Similarly D supplies material to the E – viz. retailers and whatsoever profits are made on this transactions are shown on its balance sheet and due taxes are paid to the Govt.

Thus, what we find that generally flow of goods takes place from A to E, there is a value addition at each stage of supply chain, profits are made at each stage and due taxes are paid to the Govt. Now, let us see the concept of supply chain in associated companies in context of transfer pricing.

Supply Chain in Associated Companies (Scenario 2)

In the above diagram 1 of supply chain, at each stage, the parties involved are separate entities, which means they are not related with each other. Each one is making its efforts to maximize its profit and the transactions are done at negotiated market driven prices. However, to maximize the benefits of supply chain the concept of integrated supply chain is extremely relevant and advocated so as to remain competitive in the markets.

Now, let us consider the diagram 2 showing flow of goods between the related companies. The company C the MNE (The parent company) having its subsidiaries namely SA and SB. To manufacture the end products, it will procure raw materials from SA and would like to organize intermediary processing in the plant of company SB and will make payment to both SA and SB as per the administrative prices – that is the prices decided by C itself. These may or may not be market driven prices based on demand and supply conditions. Pricing for such transactions are known as the transfer pricing (TP) and when these transactions pertain to across the borders of a country then are known as international transfer pricing (ITP). In practice, however, international transfer pricing is very frequently also known as transfer pricing.

Diagram 2: Supply Chain in context of transfer pricing (Scenario 2)

SA Subsidiary of MNE "C"		SB Subsidiary of MNE "C"	C Multinational Enterprise (MNE)	D	E
Raw materials manufacturers		Intermediate products manufacturers	End product manufacturers	Wholesalers and Distributors	Retailers

Flow of Material



ABUSE OF TRANSFER PRICING

Thus, the transaction between related companies – viz. C, A and B are transfer pricing transactions because these companies are related to each other. Transactions, however, may or may not be at the market driven prices. In case these transactions are at market driven prices – say C is paying same price to SA as if it would have paid to company A (not related of diagram 1) or to SB the same price as if it would have paid to company B (not related of diagram 1), then there is no question of abuse of transfer pricing. But historical evidences confirm this does not happen and these prices are not the market driven prices based on the overall demand and supply conditions, but indeed are manipulated prices – under or over-prices as shown on invoices. When this happens, the situation is known as abuse of transfer pricing.

In this scenario while manipulating pricing policies with an objective of global profit maximization, the company C will pay higher prices to SA and SB so as to show less profits in its balance sheet and pay little/low corporate taxes in the host country because the rate of taxation is high in the host country. Whereas, its subsidiaries in SA and SB which may be located in some other countries (tax heavens) where taxation rate is very low will pay less tax in these countries in spite of getting high prices from the company C which is operating in the host country. Thus, the game of over invoicing or under invoicing to evade the taxes and maximizing the global profits is known as abuse of transfer pricing. According to Favourate et. al. (2021) “The abuse of transfer pricing by multinational enterprises (MNEs) is a topical issue the world over. Abusive transfer pricing results in the erosion of tax bases and profit shifting from countries with high tax rates to those with lower tax rates, thus enabling tax avoidance and evasion”. As stated (Chugan 2014) “the abuse of international transfer pricing is not a new phenomenon and the numerous evidences and can be seen in the literature (Chandrashekhar & Purakayastha, 1982; Chugan, 1999 and 2010; 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; Venue, 1983). Even today, in many parts of the world, taxation authorities have been finding new cases for abuse of transfer pricing”.

Arm’s Length Pricing (ALP)

The prices which are determined by the forces of demand and supply – the market prices of good or service supplied are known as Arm’s Length Prices. It is the real price at which the transaction to take place. The term “Arm's length” is an expression which is commonly used to refer to a transaction in which two or more unrelated and unaffiliated parties agree to do business, acting independently and in their self-interest. An arm's length transaction, therefore, refers to a business transaction in which buyers and sellers act independently without one party influencing the other. Arm's length transactions assert that both parties act in their own self-interest and are not subject to pressure from the other party. As per Mishra (2019) “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 (AEs) with the prices carried out between independent entities.”

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". Jain (2021) while explaining the concept of ALP states that the "The ARM's length principle is the fundamental principle within Transfer Pricing. The purpose of this principle is that where there is any transaction between two related parties (AEs), the price charged / received in such transaction should be equivalent or comparable to the price that would have been charged / received, if the transaction was between unrelated parties. The relation between the parties, should not affect the price at which transaction is entered, i.e., there should be no discounts offered/premium charged, or other concessional treatments in the price, merely because the two parties are related".

Supply chain in context of transfer Pricing.

When supply of goods and services take place in a scenario 2, (as explained in the diagram 2 above), it may be described as the "supply chain in context of transfer pricing" because the entity which supply goods and the entity which receive goods are related to each other and such transactions are known as transfer pricing transactions. In case, these transactions pertain to cross borders supplies, these are known as international transfer pricing transactions. Such transactions are subject to laws pertaining to international taxation and are viewed under the transfer pricing legislation of the respective countries. Therefore, supply chain operations need to be managed in line with the transfer pricing legislation of the respective countries.

Issues and Challenges of Supply Chain in Scenario 2

Supply Chain transactions which takes place under the scenario 2, may results in disputes between the tax payers (MNEs) and the taxation authority of the jurisdiction where MNE is operating. Thus, due the malpractices or abuse of transfer pricing there may be disruptions in the smooth movement of global supply chain. As stated "Due to abuse of transfer pricing the disputes between the taxation authorities and multinational enterprises are on increase and impose a major disruption 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 (Chugan and Panchal 2022)". According to Soan (2014) around 60% of the global trade transactions that take place are carried out in a corporate groups".

Solutions

Issues and challenges as mentioned above may be legitimately managed by adopting any one of the following three methods:

1. Arm's Length Pricing (ALP)

Taxation authorities have their legitimate right to have doubts that transactions in scenario 2 may have taken place under the condition of abuse of transfer pricing. While scrutinizing the invoices of such transactions, if department feels that such transactions are not at Arms' Length Price (ALP), they may raise a question and issue demand notice to tax payers. Now, it is on the part of MNEs (the tax payers) to prove that the transactions were at ALP so that dispute may be solved. This calls for the convincing documentary evidences showing that such transactions were at the ALP so as to clarify the doubts of taxation authorities. Provisions 92 to 92F of the Indian Income Tax Act states and specify that such international transactions between associate companies be computed according to Arm's Length prices (ALP) so as to avoid any loophole that might get exploited by companies to evade tax.

The other solutions to avoid disputes are Advance Pricing Agreement (APA) and Safe Harbour Rules (SHRs) as explained below:

2. Advance Pricing Agreement (APA)

Advance pricing agreement (APA), in a simple words, is an agreement between a taxpayer (MNE) and the taxation authority to decide in advance the transfer pricing methodology to decide the pricing of international transactions that will take place between the taxpayer (MNE) and its subsidiary (related/affiliated parties). Once, the APA is concluded and signed, the agreed methodology is applied for the specified period of time as per terms and conditions of the APA.

The APA system brings in more transparency and clarity for a taxpayer (MNE) in terms of tax risks and possible exposure to such risks so that there are no disputes with taxation authority. According to OECD (2017), 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". 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 (Chugan and Panchal, 2022).

As stated by MOF (2023) "The APA Scheme endeavours to provide certainty to taxpayers in the domain of transfer pricing by specifying the methods of pricing and determining the arm's length price (ALP) of international transactions in advance for a maximum of five future years. Further, the taxpayer has the option to roll back the APA for four preceding years, as a result of which, tax certainty is provided for nine years. The signing of bilateral APAs additionally provides the taxpayers with protection from any anticipated or actual double taxation". The popularity of acceptance of APAs by the Indian tax payers may be gauged from the fact that in FY 2022-23, CBDT had entered into a record number of 95 APAs for the first time in any financial year so far. As per CBDT, FY 2022-23 has been a record breaking year for maximum number of APAs signed. As the year was nearing end, a record - the largest number of single day signings in the history of the programme was also created with a total of 21 APAs signed in a single day - on 24th March, 2023. With this, the total number of APAs comprising 420 unilateral APAs and 96 bilateral APAs has now gone to 516 by the FY 2022-23.

3. Safe Harbour Rules (SHRs)

In order to reduce the increasing number of transfer pricing audits and prolonged disputes, the Finance (No.2) Act, 2009 w. e. f. 01.04.2009 inserted a new section 92CB to provide that determination of arm's length price (ALP) under section 92C or Section 92CA shall be subject to **safe harbour rules**. Vide this amendment, the Government of India had empowered the CBDT to make Safe Harbour Rules. "Safe harbour" was defined to mean circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee (Cogent 2023).

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 (Chugan and Panchal 2022).

The eligible assessee under Safe Harbour Rules in India has been defined in Rule 10TB. The Board has now amended Rule 10TD(3B) to further extend the applicability of Safe Harbour Rules until Assessment Year 2023- 24.

The eligible assessee is as under (Cogent 2023):

1. An assessee who is engaged in providing software development services or information technology-enabled services or knowledge process outsourcing services, with insignificant risk, to a non-resident associated enterprises.
2. Who has made any intra-group loan
3. Who has provided a corporate guarantee
4. Who is engaged in providing contract research and development services wholly or partly relating to software development, with insignificant risk, to a foreign principal
5. Who is engaged in manufacture and Export of core or Non-core Auto Components
6. Who is engaged in Low value-adding Intra-group Services

APAs v/s Safe Harbour Rules (SHRs)

Both SHRs and the APAs have been successful in reducing the disputes and litigation in determination of the ALP and provide the solution for conducting smooth business across the borders, however, it is evident from the eligibility criterion of assessee of SHR that a company may opt for SHR, if it is engaged in any of the above specified activities. It means every company cannot go for it. Whereas, in case of APA there is no industry or sector specific

criterion. It is general scheme and open for all sectors and any company may approach the taxation authority for APA.

Thus, the choice between the APA and SHR is only for those taxpayers who are eligible for the SHR. Based on the cost benefit analysis taxpayers may opt either SHR or APA which suits them most. It may however, be noted that SHR give tax certainty to the tax payers for the future years on general terms and conditions as specified in the sector specific schedules whereas, APA system gives certainty to tax payers on case to case basis and that too not only for the future years but also for the previous four years (roll back years) if desired by the taxpayers. As per Mint (2019), “APA provides an opportunity to taxpayers to negotiate and finalise the arm’s length price (ALP) of its intra-group transactions or the manner for computing such ALP, with the Indian tax authorities for a fixed period. On the other hand, safe harbour provisions prescribe minimum return/price (such as a minimum return of 17 to 18% on total operating costs for a captive software developer) for a specified list of intra-group transactions, which, if followed by the taxpayer, would be accepted by the Indian tax authorities”.

“In case, neither APA nor SHR, is acceptable to 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 (Chugan and Panchal 2022)”.

CONCLUSION

Disputes and litigations for abuse of transfer pricing with the taxation authority are bound to happen in context of global supply chain if such transactions are between the related / associated companies. It is, therefore, extremely important for such companies to find a suitable solution to avoid such disputes / litigations and conduct their global supply chain operations smoothly without affecting their profitability. And for that, three ways may help the companies. Firstly, it should be ensured that such transactions are at ALP and for that convincing documentary evidences are to be kept ready to show the taxation authority if problem / dispute arises. Alternatively, in case a company is engaged any of the activity covered in SHRs, may opt for SHRs, if desire so. The other way is to opt for the APA system and to sign a contract with the taxation authority in advance so that there is no dispute at later stage. The companies eligible for SHRs also have the option to go for APA and they may decide on merits, based on the cost benefit analysis, either to go for SHRs or APA. If any of these three options is opted by MNEs for their international supply chain operations with associated companies, they may conduct and manage their business without having issues / disputes /litigations with the taxation authorities.

REFERENCES

- [1] Chandrashekhar, C. P. and P. Purkayastha (1982). “Transfer Pricing in Indian Drug Industry: An Estimates and its Implications”, *Social Scientist*, Jan., pp. 3-10.
- [2] Chugan, Pawan Kumar (1999). “International Technology Transfer”, Mumbai, Himalaya Publishing House.
- [3] Chugan Pawan Kumar (2010), “International Transfer Pricing in India: The New Era of Advance Pricing Arrangements to Benefit both MNCs and Taxation Authority”, in Mehta Shantanu, and Neeraj Amarnani, pp. 505-522. <http://ssrn.com/abstract=1768627>
- [4] Chugan, Pawan Kumar (2014). Transfer Pricing and MNCs: Safe Harbour Rules (SHR) and Advance Pricing Arrangement (APA) to Facilitate FDI and Reduce Litigation in India. In “Emerging Paradigms in Corporate Finance and Regulatory Framework, Eds. Prag Rijwani and Neeraj Amarnani, ISBN: 978-81-923049-3-9, Print Quick, Institute of Management, Nirma University, Ahmedabad, Jan. , pp. 355-367. <https://ssrn.com/abstract=2383269> accessed on Jan. 20, 2024.
- [5] Chugan Pawan K and Panchal Nilam (2022). Managing Global Supply Chain: Transfer Pricing Issues and Solutions. *International Journal of Management, Public Policy and Research*, E-ISSN: 2583-3014, B. K. School of Professional & Management Studies, Gujarat University, pp.34 – 41. SSRN: <https://ssrn.com/abstract=4145652>
- [6] Cogent (2023). Safe Harbour Rules. <https://cogentprof.com/safe-harbour-rules/> accessed on Jan. 08, 2024.

- [7] Deo, Som (1975). "Multinational Corporations and the Developing Countries", Economic Affairs, August, Vol. 20, No. 8.
- [8] Deo, Som (1977). "Modus Operandi of Drug Multinationals", Economic Affairs, April, Vol. 22, No. 4.
- [9] Deo, Som (1986). "Multinational Corporations and Third World", New Delhi, Ashish Publishing House, 1986.
- [10] Favourate Sebele-Mpofu, Eukeria Mahiri and Samantha Chantelle Schwartz (2021). An exposition of transfer pricing motives, strategies and their implementation in tax avoidance by MNEs in developing countries. Cogent Business and Management. Vol. 8, Issue 1. <https://www.tandfonline.com/doi/epdf/10.1080/23311975.2021.1944007?needAccess=true&role=button> accessed on Jan. 16, 2023.
- [11] Jain Arinjay (2021). Arm's Length Transfer Pricing. June 4, <https://sortingtax.com/arms-length-price/> accessed on 16 Jan. 2023.
- [12] Krishna, Sridhar (1984). "A Note on Transfer Pricing – Some Theoretical Issues and Empirical Evidences", Social Scientist 12, pp. 22-32.
- [13] Kumar, Nagesh (1984). "Social Cost Benefit Analysis of an Export Oriented Project with Foreign Collaboration", Industry and Development, No. 10, UNIDO.
- [14] Lall, Sanjaya (1973). "Transfer Pricing by Multinational Manufacturing Firms", Oxford Bulletin of Economics and Statistics, Vol. 35, p.p. 173-95.
- [15] Lall, Sanjaya (1979). "Transfer-Pricing and Developing Countries: Some Problems of Investigation", World Development, Vol. 7, pp. 59-71.
- [16] Mann, T. S. (1982). "Transfer of Technology", Bombay, Himalaya Publishing House.
- [17] Mishra, S. (2019). Transfer Pricing in India. July, 26. <https://taxguru.in/income-tax/transfer-pricing-india.html> accessed on 8 Jan., 2022.
- [18] Mint (2019). Transfer Pricing: Advance Pricing Pact vs Safe Harbour Provision.
- [19] <https://www.livemint.com/money/personal-finance/transfer-pricing-advance-pricing-pact-vs-safe-harbour-provision-1557417827008.html> accessed on Jan. 08, 2024.
- [20] MOF (2023). CBDT Signs 95 Advance Pricing Agreements in FY 2022-23, Ministry of Finance, Govt. of India. PIB, 31 March. Accessed on Jan. 4, 2024. <https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1912685>
- [21] OECD. (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*. Retrieved from OECD: <https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm> (accessed on Feb. 7, 2021). Details also available on https://www.un.org/esa/ffd/wpcontent/uploads/2016/12/13STM_TPM_B1_Introduction_TP_20161125_v8_clean_A.pdf accessed on Jan. 17, 2022.
- [22] Peter, Roost (2006). "How Multinational Corporations Avoid Paying Taxes", Scoop Independent News, November 22. <http://www.scoop.co.nz/stories/HL0611/S00390.htm>
- [23] Ramanujam, T.C.A (2001). "How to Make Transfer Price Effective", <http://www.hinduonnet.com/businessline/2001/06/29/stories/042920ma.htm>
- [24] REGTPG (2002). "Report of Expert Group on Transfer Pricing Guidelines", submitted to the Government of Indian, Ministry of Finance and Company Affairs, August.
- [25] Soan, A. (2014). Advance Pricing Agreements. *Asia Pacific Bulletin*. Retrieved from IBFD: https://www.ibfd.org/IBFD-Products/Journal-Articles/Asia-Pacific-Tax-Bulletin/collections/aptb/html/aptb_2014_01_in_1.html accessed on February 7, 2021
- [26] Subrahmanian, K. K. and P. Mohan, Pillai (1976). "Implications of Technology Transfer in Export-led Growth Strategy", Economic and Political Weekly, Oct. 30, pp. 1729-35.
- [27] Taxman (2021). What is Arm's Length Price?. <https://www.taxmann.com/post/blog/764/what-is-arms-length-price/> Accessed on Jan. 13, 2022.
- [28] Vaitsos, C.V. (1974). "Inter – Country Income Distribution and Transnational Enterprises", Oxford, Oxford University Press.
- [29] Venu, S. (1983). "Transfer Pricing by Multinational Corporations", Commerce Publications Ltd. Bombay