

## Chapter 1

### Introduction

#### 1. Subject:

- 1.1 The Government of India endeavors to make India as a 'factory of the World' and has launched the "Make In India" Campaign. Decision to locate a business is influenced by a host of factors, important one being profitability, ease of doing business, certainty of regulatory environment and rule of law. Taxation is an important factor in affecting investment decision in two broad ways: Firstly, business are sensitive to tax rates. Higher the tax rate in a country, lesser the attractiveness. Secondly, it is the nature of the tax administration and the way it is implemented affects the business decision significantly<sup>1</sup>. It is therefore to be expected that with launching of make in India campaign, the tax regime would get aligned to the imperatives of this campaign.
- 1.2 The Government of India has also laid stress on technological up gradation of economic enterprises<sup>2</sup>. For this, India has been taking numerous measures to attract Foreign Direct Investment (FDI) and make it attractive for the MNEs to set up base in India. The main idea behind this approach is that FDI would bring new technology as well as managerial innovation and their diffusion would allow the economy to more efficiently exploit its resources and become globally more competitive.
- 1.3 The above objective implies that there should be nuanced and well calibrated taxation policy, especially to govern such transactions

which have the potential to bring better technology. Taxation of MNEs and similar business enterprise therefore cannot be governed by the simplistic motive of revenue maximization.

- 1.4 The most relevant field of taxation for these types of economic enterprises is taxation of intangibles across different tax jurisdictions. These issues are dealt by the Transfer Pricing (TP) regulations contained in Chapter X of the Income Tax Act, 1961(the Act)<sup>3</sup> and the rules formulated under Income Tax Rules , 1962<sup>4</sup>. This is quite a complex subject and broad contours are outlined in succeeding paragraphs.
- 1.5 The taxation of intangibles like patents, trademarks is a contentious topic for the tax authorities of both Developed Countries (DC) as well as the Developing and Emerging Economies (DEEs)<sup>5</sup>. Transactions related to intangibles are dominated by Multi National Enterprises (MNEs) which resort to business erosion and profit shifting (BEPS) strategies to make use of mismatches and gaps between tax rules of different jurisdictions<sup>6</sup>. In the aftermath of the financial crisis faced by the DC in 2008, the tax authorities of DC have realized the need for coordinated action not only among themselves but also with the DEEs.
- 1.6 While most of the MNEs are based in DC, an increasing and large part of the transactions in intangibles is conducted with the DEEs<sup>7</sup> which need technology to raise the standards of living of people in their country. Usually, while the main company of the MNE would be registered in a DC, it will have Associate Enterprises(AE) in other countries which in turn would invest in third countries. This

investment in a third country can be in terms of technology, capital or management. DC would like to tax the income arising from transaction in intangible on the grounds that the concerned owner of the intangible is a resident of their country. On the other hand the DEEs claim the right to tax the same on the ground the transaction takes place in their country. Apart from the fact that the MNEs are located in a different tax jurisdiction than the one where the transaction takes place, the situation is complicated by the fact that many transactions take place over the internet. Many times the transactions are undertaken under complex hybrid contracts. All these factors lead to anomalous situations<sup>8</sup>. It has been estimated that sixty percent of the world trade is among the MNEs. It has been the contention of tax authorities all over the world that intra group trade enables the MNEs to control the prices of the transactions among themselves<sup>9</sup>.

- 1.7 With the introduction of Transfer Pricing (TP) legislation in India in 2001, vide Finance Act, 2000<sup>10</sup>, intra group dealings of MNEs have come under scanner of the tax authority. Detailed transfer pricing provisions were ushered in so as to protect Indian tax base and to prevent shifting of profits from India to other jurisdictions by MNEs by way of manipulation of transaction prices. The internationally accepted principle underlying transfer pricing determinations is the arm's length principle, which requires that for tax purposes, related parties must allocate income as it would be allocated between independent entities in the same or similar circumstances. When independent enterprises transact with each other, the conditions of the transaction are generally determined by market forces. When

associated enterprises transact with each other, their relations may not be directly affected by market forces in the same way<sup>11</sup>.

1.8 Fourteen years have elapsed since the Indian TP Regulations were introduced. During this period interpretations applied to TP provisions have changed, new thoughts have evolved, a plethora of decisions have been delivered by the Indian Courts and consequential amendments to the law including retrospective amendments have been introduced to negate some of the judicial precedents. Implementation of the TP regulation continues to remain uncertain and MNEs operating in India have over the years, suffered substantial adjustments to the reported values of their international transactions. In line with this trend, an emerging area of transfer pricing controversy has been the treatment of expenditure incurred for Advertising, Marketing and Publicity ('AMP') which are also called 'marketing intangibles'. 'Marketing Intangibles' and its arm's length determination, refers to 'excessive' payments or 'non-routine' payments made for AMP activities undertaken by Indian taxpayers in relation to sale promotion of goods manufactured or traded by them in India. The issue of marketing intangibles gets triggered from the expense incurred by the Indian taxpayers on the AMP activity, where the brand owner is the foreign parent entity.

1.9 The tax Authorities in India have tried to tax transactions where such anomalies exist. The government had also resorted to retrospective taxation and amendments and clarifications to

protect its revenue base<sup>12</sup>. All this led to an increase in litigation between the tax authority and the tax payers which has clogged the courts. Lack of predictability in the tax regime has decreased the attractiveness of the Indian market for the MNEs with a decreased flow of capital and technology from abroad which may have negative implications for the growth rate in India.

- 1.10 In view of the same it is imperative to look at the issues and the policy concerns regarding taxation of cross border transactions involving intangibles as this has an important role in attracting much needed FDI in India. It may be kept in mind that it is a nascent subject with the rules of the game still being decided as the DCs and the DEEs try to act in concert to identify tax gaps and take suitable action under the aegis of OECD.
- 1.11 The subject regarding taxation of intangibles is discussed in this report with special reference to marketing intangibles. The subject is vast but concentration on one sector gives an inkling of the problems faced in other sectors also.
- 1.17 There is an increase in the litigation between the taxpayer and the Income tax Department with regards to transfer pricing especially of intangibles. While the tax administration and the courts look at the objective of revenue maximization, the larger objective of having a stable policy regime to attract FDI to make India a manufacturing hub may take a back seat.
- 1.18 The study poses only one research question: it assumes that the 'make in India' campaign is a national priority and since taxation of intangibles too is levied by the Central Government, it poses the

question as to whether the TP regime is consistent with the India's development agenda. It concludes that this does not seem to be the case and maximization of tax revenue seems to be overriding objective of India's tax administration. It further concludes that some of the recent judgment of the courts in this regard have also failed to look at the big picture and by affording a few crore rupees of extra tax revenue seems to have ignored the dynamic nature of international capital.

### **Methodology:**

- 1.19 The study is based on India's TP regime structure as provided in its tax code, OECD framework, tools developed by the United State Tax Administration. A large part of study is scrutiny of some of the recent court judgment. As mentioned above, the focus of the study is treatment of 'Marketing Intangibles'. While the subject is important in its own right, it is to be clarified that treatment of other intangibles like 'Royalties' and Fee for Technical Services' are equally complex and important. In addition, an emerging area of dispute is what is considered as treatment of 'Local Savings' which essentially means advantage accruing to an enterprise due to inexpensive labor or other such factors of production. This is an important area in countries like India ( where labor is relatively inexpensive) and China ( where land being owned by State is often given to business enterprise at a concessional rate). The choice of marketing intangibles as a focus of study is based on the rationale that this brings about major issues involved in taxation of intangibles which are *mutatis mutandis* applicable to other intangibles.

1.20 As stated above, the methodology involves scrutinizing the TP regime in India, its comparison with guidelines issued by OECD or UN manuals and detail examination of certain court judgments to see whether there is any consideration other than revenue maximization which shapes the Indian stance in TP regime.

**Limitations:**

1.21 The taxation of intangibles is a contentious issue. Many issues are locked up in the courts. Moreover transfer pricing is a vast subject whose complexities are beyond the scope of this report. It is proposed to study some issues and policy concerns of the Transfer Policy Regime in context of the national development agenda by using marketing intangibles as an illustration. All these factors pose a limitation on the conclusions drawn but which are nevertheless indicative.

**Literature review:**

1.22 Technology is increasingly becoming an important input for economic growth of a nation. MNEs generally based in DCs are the main inventors and innovators and FDI is the vehicle through which technology gets dispersed to DEEs. Globalisation has brought about changes in political economy and governance as discussed in the works of Joseph E. Stiglitz et al 'Stability with Growth - Macroeconomics, Liberalisation'<sup>13</sup> as well as Sliglitz's 'Making Globalisation Work'<sup>14</sup>.

1.23 OECD 'Action Plan on Base Erosion and Profit Shifting'<sup>15</sup>, 2013, describes how changes have taken place in the structure of MNEs