



TRANSFER PRICING AND LOCATION SAVINGS: POSITIONS OF INDIA AND CHINA

“Review of the inter-relationship between the Country
policy and the OECD”

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List of abbreviations

TP: Transfer Pricing

UN: United Nations

LCJ: Low Cost Jurisdiction

HCJ: High Cost Jurisdiction

LSA: Location Specific Advantages

ALP: Arm's Length Principle

MNE/MNEs: Multinational Enterprise/ Enterprises

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CHAPTER 1: Introduction

Abstract :- Transfer Pricing is an hot debated topic, in the context of international tax law. The OECD promptly releases soft law measures which may serve as a basis for interpretation in any situation involving international transactions between entities located in different jurisdictions. The scope of this thesis is to analyze two of the latter, namely China and India, as the biggest representative of the Asian block and the major economies of the BRICS ones. The context, is either the transfer pricing landscape and, a particular issue in the transfer pricing matter: location savings. This concept has been controversial for multiple reasons, starting from the fact of whether they actually exist in practice. In this thesis various concepts and dynamics are analyzed, involving high cost countries and low cost countries, profit shifting practices through the abuse of transfer pricing. The curiosity that moved the author to research, is to see what kind of interrelation occurs between the OECD, which historically has been the association of category of the developing Countries and the two emerging powers, China and India. As non-members, is there the risk to see a counter opposition of these two parties? In the development of such context, what do these Countries have in common and what are their claims are exposed in this dissertation.

1.1 Background

Thanks to the advent of the information age¹ and the globalization of markets² and businesses³, the opportunities for business to delocalize in more advantageous economic region in order to optimize the costs associated with the production and distribution of goods, have been growing ever since.

When it comes to multinational enterprises (hereinafter MNEs), it is natural to establish affiliated entities in order to shift profits for multiple reasons. One of the main reasons, is for tax purposes, since it is directly related to the taxable corporate income⁴. The main mechanism that allows profit shifting for tax purposes is transfer pricing.

Transfer pricing can be referred as the method MNEs use to optimize the allocation of costs and revenues among subsidiaries, divisions and joint ventures within related entities and/ or subsidiaries.⁵

When it comes to strategic management, the choice of having an affiliated entity in a certain jurisdiction, falls on the location that give the most competitive advantages. These are given by the geographical location, and are also called Location Specific Advantages. Once established an efficient operation point as a subsidiary, it is possible to operate with an integrated business operation process that runs between affiliated entities and parent companies. Location Savings in particular, are an hot debated topic in the transfer pricing landscape, due to the issues that brings when determining the correct pricing of a transactions between affiliated entities and in which measure profits should be allocated. This is because affiliated entities within

¹ Castells, M. (1997). Power of identity: The information age: Economy, society, and culture. Blackwell Publishers, Inc..

² Levitt, T. (1993). The globalization of markets. Readings in international business: a decision approach, 249.

³ Cooper, J. C. (1993). Logistics strategies for global businesses. International journal of physical distribution & logistics management, 23(4), 12-23.

⁴ Theresa Zinn, Nadine Riedel, Christoph Spengel, 'The Increasing Importance of Transfer Pricing Regulations: A Worldwide Overview', vol. 42 Intertax, Issue 6/7, pp. 352-404

⁵ C. Horngren, A. Bhimani, G. Foster, S. Datar, Management and cost accounting, Financial Times/Prentice Hall, Harlow (2002)

MNEs are located in two different jurisdictions, namely the high cost jurisdiction (hereinafter HCJ) and the low cost jurisdiction (hereinafter LCJ).

The typical dynamic that occurs, can be framed in the outsourcing of processes from the HCJ to the LCJ in order to realize the optimal condition for profits to arise. This is usually an argument that depends on costs of production, but the phenomenon of transfer pricing has showed that it is relevant also, under a tax perspective.

In the object of this proposal, the jurisdictions analyzed will be two of the ones part of the BRICS⁶, namely India and China.

1.2 Research questions.

It is possible in the author's view to compare the two Countries exposed above with each other, in order to individuate common points and diverging ones. A comparative research question follows:

- *Can India and China policies on transfer pricing converge and Location Savings converge? If so how will it shape the future interactions in the international framework?*

The linked sub-questions will define step by step the core of the dissertation.

- What is the current view of India on location savings?
- What is the current view of China on location savings?
- Comparing the positions of the two jurisdictions, are there any differences or they meet the same demands on local taxpayers?

1.3 Methodology

The methodology used for the analysis of this topic will focus on the doctrinal approach of scientific works in the field of economics, tax and law.

In combination to this, a black letter approach is necessary to analyze and compare the international the OECD and the UN approach with related soft law norms, along with the respective jurisdiction judicial bodies and domestic provisions.

When dealing with the domestic position of the two Countries, a relevant case law analysis is required to understand the position of the respective National Tax Authorities in the case where they have been involved.

1.4 Delimitation.

The focus of this thesis is the review of the position of China and India as the biggest representatives of the Asian block, and the two biggest economies of Asia, in the matter of transfer pricing and the treatment of intangibles. To narrow down further, it is proposed, in the context mentioned above, how this is relevant to

⁶ Namely Brazil, Russia, India, China and South Africa. See: <http://infobrics.org/brics> countries

Multinational Enterprises tax planning and their practices, how this affects profit shifting towards those areas and what are the tax benefits acquired. In this view, it is expressed as the central topic of this thesis the view of the two States, and see if this reality of things is compatible with their view and the international framework.

- In the field of international tax, the author examines only the transfer pricing issues. Although the general mechanisms are touched, the focus is on intangibles, their role in transfer pricing in transactions between corporate groups, ultimately the difficulty of connecting intangibles asset in an unequivocal way to a single jurisdiction⁷.
- Concerning the main actors in this context, the OECD, which has a huge part in the international policies relating the economic global development, is also crucial in the field of international taxation. The UN, also has a central role in international policies, also in transfer pricing since the constitution of the committee of tax experts as a part of the ECOSOC⁸, therefore it is also treated in this thesis.
- To have a clear image of the global picture in the field of international transfer pricing, the-policies of other geopolitical areas of importance, hence the EU, US, will be briefly dealt to understand also the interaction with the arm's length principle.
- Of the BRICS economies, only India and China will be treated. This means that the author will report their position, first in their opinion about the OECD solution to profit shifting, their view on how to solve the profit shifting and tax base erosion problem.
- The author will conclude with his personal opinion, while comparing the different instances and demanded safeguards by the target Countries (China and India) and the international context

1.5 Chapters overview.

- The first chapter will deal with the general issues put forward by the OECD action plan⁹. Before proceeding with presenting the policies adopted by the international bodies in the matter of international tax (profits shifting, transfer pricing), the author will first introduce general concepts of transfer pricing and how they relate to the genus of intangibles. This involves explaining the mechanisms adopted by Multinational Enterprises (hereinafter MNEs), in order to minimize the tax burden, in the context of international tax planning. The author will show how MNEs cross-border transactions affect the total taxable base of the corporate group, with consequences on the tax liability. It is in fact rather difficult and burdensome to determine the exact value of a transaction

⁷ [Pablo A. Hernández González-Barreda, 'A Historical Analysis of the BEPS Action Plan: Old Acquaintances, New Friends and the Need for a New Approach', 2018, para 1.2.](#)

⁸ It refers to United Nations Economic and Social Council) on "International cooperation in tax matters" and their works after the introduction of the UN Manual on Transfer Pricing in Developing Countries.

⁹ OECD, Addressing Base Erosion and Profit Shifting (OECD 2013); OECD, Action Plan on Base Erosion and Profit Shifting (OECD 2013)

involving intangibles, either for their nature¹⁰, either for a specific characteristic¹¹, either because it is difficult to collect enough data¹². This is necessary before explaining the role of other elements of tax planning, which heavily influences the MNEs dynamic in shifting profits from one Country to another. The author therefore will introduce and explain these elements, which in the opinion of the author infer mainly in the categories of: Locations Savings, Location Specific Advantages and Market Premiums. Although there are connecting traits, these terms are not to meant be used interchangeably, since as it will be highlighted, they differ in the economic reality. Last but not least, the chapter will be concluded with enumerating the problems that States have in taxing intangibles, and the same chapter will mention in connection the international response on this issue, before proceeding to the next one.

- From the second chapter will be introduced the policies adopted by the international bodies in the context of international tax. The chapter will be focused mainly on the OECD action plan against the profit shifting and the consequent base erosion which can constitute a heavy problem for the budgeting\tax revenues of certain States. The author will explain the difference between developed and developing Countries, and whether it is the attractiveness of a low global tax rate or there is the influence of the above cited factors, (Market Premiums, Location Specific Advantages, and Location Savings). This because of the underlying connection with the tax planning of MNEs and profit shifting. In the last part of the same chapter, it is mentioned also how the main geopolitical areas interact with the OECD policies¹³After having dissected the international tax framework relating to transfer pricing and location savings the author will pass on analyzing the jurisdictions chosen for this thesis. Without any specific order, the author starts with India, which will be the Country focus of the chapter three.
- Chapter four will see China as the focus of this chapter
- A final concluding chapter will answer the main research question, including the opinion of the author, who will try to find a trait d' union between the international policies, and the needs of the aforementioned Countries, as the main representative of the Asian block, and as rising economic Powers.

¹⁰ Pablo A. Hernández González-Barreda, *supra*, para 1.2

¹¹ This is the case of hard-to value intangibles. See: Martin Lagarden, *Intangibles in a Transfer Pricing Context: Where Does the Road Lead?* 2014, IBFD, p.346

¹² OECD, OECD (2014), *Guidance on Transfer Pricing Aspects of Intangibles*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/9789264219212-en>.

¹³ The author refers to EU and relative legal instruments to implement the arm's length principles. Also, the US guidelines on Transfer Pricing will be briefly treated, as it may open a ground for confrontation with other solutions.

CHAPTER 2:

Location Savings, LSAs and the International Perspective.

2.1 Location Savings and Location Specific Advantages: breakdown.

Location Savings can be firstly circumscribed as a series of advantages realized by a corporate carrying out business activities (usually a MNE), resulting from relocation of such activities from a high cost country to a low cost country, consequently realizing economic rents. Specifically they result in net cost savings, which are obtained by confronting cost savings with cost dis-savings.

The factors¹⁴ that heavily influence the amount of cost savings can be found in the diminished cost of labor, material, capital, know-how, logistic and infrastructure. Concerning dis-savings, they relate to certain costs necessary to carry out some operations: e.g., transportation, quality control, capital costs. There is usually a difference in prices between the factors above mentioned between the LCJ and the HCJ, which when exploited give rise to an incremental profit to be allocated to the corporate group.

Location savings can result also as revenue-enhancing effect¹⁵. This means that in a given market, there can be a high demand for determined prices but also a limited market access to other competitors. The advantage of an MNE operating under these conditions, is a bonus, since it will benefit from increased transaction quantities than it would be compared to a standard market. This characteristic is however related to the broader concept of Location Specific Advantages, because directly related to a specific territorial location.

The concepts of Location Specific Advantages entails certain factors that are directly connected to the financial situation of the MNE in relation with the location of choice. These can relate to factors of production and distribution that allow an MNE to achieve the same result in terms of productivity or distribution, with the same means, but with less cost. Therefore it is obvious to trace the economic advantage of selling products at a market price in the high cost country, which considerably higher than the production cost incurred in the low cost country. The difference between the two is called “economic rent”. The joint effect of the net cost saving with location specific benefits gives rise to Location Specific Advantages.

Difficulties can arise when in case of a developing country like the BRICS ones, where the local market comparable are more than often not available. This problem is common among developing countries not only for LSAs, but also under a general transfer pricing perspective, since comparable are necessary for a correct application of the arm’s length principle. A reason for this can be found in the relocation dynamics of MNEs

¹⁴ For example, bargaining power and the level of ownership in equity participation in: Lecraw, D. J. (1984). Bargaining power, ownership, and profitability of transnational corporations in developing countries. *Journal of international business studies*, 15(1), 27-43.

¹⁵ M.A. de Lange & P.W.H. Lankhorst, The Impact of Location Advantages on the Transfer Pricing of Multinationals: On the Chinese Love for European Designer Handbags and Lower Production Costs in India, 21 Intl. Transfer Pricing J. 4 (2014), Journals IBFD d

because, the process of relocating portions of supply chain units or production units it is done by MNEs and not domestic enterprises operating independently.

In international taxation, LSAs problematics have been known since the Compaq case¹⁶, but is over the past few years that this topic has received more attention from the international bodies¹⁷. The main issues from a taxation point of view, is first the remuneration of affiliated entities in LCJs. The author will explain briefly on how the remuneration for these entities has been and it is commonly computed under the international transfer pricing rules and consequently, the allocation of the profits between the entities under the arm's length principle.

2.2 US Case Law: Sundstrand Case as a precursor.

The main principle it is stated in the Section 482 of the Internal Revenue Code , according to which the standard to be applied is that of an uncontrolled taxpayer at arm's length. It is clear in stating that in case two or more organization controlled by the same interest, the allocation should reflect the income of the entity. Following this the difference in allocation will be determined by the nature of the transfer, if it involves, tangibles and services. In the US approach the CUP is the most important for that it allows to compare the pricing in an uncontrolled transaction, between non affiliated entities. It is put in a sort of a hierarchy, since the CUP has the priority, followed by the Resale Price method and the Cost- Plus method. At last an open provision, with the fourth method being undefined. If comparables are not available, the concept of arm's length charge applies, with the exclusions of services.

The term location savings has been acknowledged for the first time in two cases involving US MNEs: Sundstrand Corporation case and the Compaq Case. US Courts analyzed in both cases the role of intellectual property and its relationship with the subsidiaries. In fact, the owner of the intellectual property, namely intangibles , retains greater market power. Greater market power results in greater bargaining power, as in both cases, the Court allocated the resulting location rents to the party that possessed intangibles. Moreover, it has been determined that, there is to some extent, there is a sharing of the benefits also in the LCJ.

Sundstrand Corporation was a US company manufacturer of specific components. The expansion in the Singaporean Market determined the setting up with a subsidiary, which enjoyed determined market conditions categorizable as a LCJ. The subsidiary paid a royalty to the parent company based on the use of Intellectual Property Intangibles, which was not proportioned to the profits made by Sundstrand Corporation. When challenged, Sundstrand Corporation highlighted that the subsidiary would sell directly to the end-customer, meaning that the benefit would be passed on..

The Court ruled that the subsidiary was having great bargaining power due to the ownership of intangibles and therefore, retain the location savings arising from the operations.

The use of the ALP, imposed that location savings arising from the transaction, are allocated based on the

¹⁶ Compaq Case in US:TC 18 Nov 1999, Compaq Computer Corporation and Subsidiaries v. Commissioner of Internal Revenue, 78 T.C.M. (CCH) 20, 1999

analysis with unaffiliated parties, since it served as a criterion for the whole allocation process. This allocation is determined by the relative bargaining positions of the respective parties, which is, in large part, determined by the competitive position and intellectual property rights enjoyed by each party. The difference in approach lies in the consideration of the ownership of intangibles as monopoly, which in the opinion of the author it is not. Also, the fact of the ownership of intangibles, does not mean that the owner should retain all the profits, as it must be carried out a proper functional analysis.

2.3 LSA: allocation and transfer pricing methods.

A common remuneration method under the transfer pricing rules is the cost-plus. If e.g., a MNE is carrying out manufacturing activity in the LCJ, the affiliated entity should be remunerated considering factors like the low-risk and the reiteration of the processes. This means that the base for the remuneration is a base cost plus a markup, which is generally calculated on the data received from comparable corporates, but in the developed economies. The consequent issue is that following this model, the party of the MNE which receives the major share of profit is the one located in the HCJ. More profits allocated in a certain jurisdiction, means a bigger taxable base, hence more revenue via taxation for the Country budget. This is why emerging economies are reacting towards these phenomena by demanding a fair allocation of profits due to the net cost savings that MNEs achieve by exploiting the LCJs peculiarities.

Continuing with the allocation of the profit deriving from savings, this is affected also on data available by comparable entities on similar transactions, in a given market. These constitute the basis for a correct pricing and, consequently to see whether an adjustment is needed at arm's length. For the tax authorities of developing Countries, it is of the foremost importance to not lose the taxing rights due to these profit shifting practices, and in the case of India and China they already expressed their position in the UN manual, but as it will be explained later in this dissertation, are pushing for the safeguarding of the local tax base favoring the taxpayers part of corporate groups, located in their jurisdictions¹⁸. Comparable entities and transactions are dealt within the OECD Guidelines and the BEPS project which will be both treated shortly.

Another point necessary to mention about the allocation of profits is the bargaining power. Bargaining power refers to the juridical and economic position of each party in the corporate group that confers the ability to leverage more profits, given the circumstances. Those for example, can simply depend on the market demand and supply, but also on the peculiarity of the affiliated enterprise. If the latter is one of the few (or the only one) to respond to the MNE standards needed for the procurement of the service, it is natural that it has a greater bargaining power compared to another manufacturer who is barely in line or under tone in relation to the competition.

Under the ALP, there are five transfer pricing methods that are prescribed in the OECD guidelines and the UN TP Manual: the cost-plus method, the CUP (comparable uncontrolled price), resale price, TNMM

(transactional net profit split method) and the transactional profit split method.

According to the OECD guidelines paragraph 2.2¹⁹ some elements may indicate the choice of one method over one other depending on the view of the controlled transaction; the availability of data for similar transactions; the possibility to confront controlled with uncontrolled transactions.

2.4. International approach: the OECD.

An important issue that an operation involving Location Savings raises is the sharing among parties and also, if part of it should be allocated to the part in the low cost country. The OECD TP Guidelines deal with Location savings in a definite settings: business restructuring operations. According to the definition contained in the TP guidelines, LS are understood as the net savings realized by a MNE that derive from a relocation operation in a low cost country. Both in the TP guidelines and the annexed paper focus on the relationship between the parties and, how the location savings should be allocated, referring to the concept of bargaining power. Bargaining power refers generally to negotiation process in MNEs, between two affiliated enterprises, to adjudicate a certain benefit, based on determined factors. As an indication, parties should determine the pricing of the transaction as they would do it in similar circumstances and, based on this, they might agree on how to share. An important concept for the parties in play is the FAR (functional assets and risks) or functional analysis method, which measures the parties bargaining power. The examples that follow in the lines of the guidelines, are built around the concept of bargaining power and having at object transfer of intangibles, which is extremely relevant in the case of the Indian market, due to the high amount of transfers involving **intangibles**. For brevity reasons, the examples are filtered to the essential. It is clear that the following example develop according to the logic of the Arm's Length Principle.

The first is written in the context of relocation of general manufacturing activities from Company situated in Country A to affiliated enterprise in Country B through contractual mean. In the next phase of restructuring, all IP assets are held by the company in Country A, which also faces higher risks since the relocating activity is highly competitive and there is the option for the company in Country A to resort to third-country manufacturers. The TP Guidelines highlight that in this case, the bargaining power tends to be stronger for company located in Country A than for the affiliated enterprise located in Country B, due to the fact in a competitive scenario, the market prices are forced to be low, resulting in an impossibility for the third party manufacturers to ask for higher prices. This means that in the sharing of profits, the company in Country B will receive a small amount of the profits.

The second, is written in the context of specialized services from a company situated in Country X to an affiliated enterprise situated in Country Y. The difference with the previous example is that there is no competitive market environment, because the company in Country Y is the only subject that can provide

¹⁹ OECD TP Guidelines para 2.2

specialized services, leading to the consequence that the bargaining power is higher for the latter. In this example location savings go to the affiliated enterprise in Country Y

The guidelines state that location savings whenever they are not passed onto customers, could be attributed to Country Y by inter alia using the transactional profit split method (PSM) because the bargaining power of Country Y enterprise is higher. Further, in its project on revising Chapter VI on intangibles, 25 the OECD systematically states that its analysis in Chapter IX-Business Restructuring applies in all cases where location savings is present and is not restricted to restructurings. The draft guidance states, in determining the location savings that are to be shared deeming related parties it is necessary to consider whether location savings exist; the amount of any location savings; the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings. It is stated that if reliable local comparable exist then those local market comparable will provide the most reliable indication regarding how location savings (not passed on to customers or suppliers) should be allocated amongst two or more AEs. Thus, when reliable local market comparable can be used to determine the arm's length price, comparability adjustments for location savings should not be required (a preference for local comparable is expressed). Conversely, it is also provided that in the absence of reliable uncontrolled prices, specific comparability adjustments for location savings are required.

(TIEAs), but especially the convention on Mutual Administrative Assistance in Tax Matters (MAAT). The signing of these international agreements show that India is actively participating on the formal aspect of the exchange of the information between tax authorities whereas there are investigations to be conducted in the case of tax evasion. Concerning Transfer Pricing, the OECD issued a revision of the TP guidelines, in particular chapter VI is what will be discussed, since it deals with the location specific characteristics.

The action plan 8 of the BEPS follows the OECD guidelines, mainly Chapter IX. It deals with the transfer pricing of intangibles in the context of location savings. In particular, it is useful for solving issues arising from the sharing between two legal entities within the same group. The action plan in question, introduces a four step approach: 1) determination of the existence of possible locations savings; 2) determination of the amount of the savings; 3) their retention (or pass on, if the benefits arising are passed on customers); 4) the method used for allocating.

This approach can be used step-by-step and from case-to-case, but it is crucial to distinguish between two situations. The first is where comparable are available, which is the clearest, since it makes it easier to determine whether there is the allocation of location savings between related entities. The second situation occurs when comparable are not available. In this situation, given the lack of reliable data, it is possible to look at other factors, such as the type and number of assets used, the risk-benefit model used, the strategic approach and other elements that have been used in a similar way by an affiliated enterprise.

2.5 International case law

The following two cases serve to understand how the issue related to the allocation of location savings has been similar in time, since the author presents these cases distancing almost fourteen years apart in time: the Compaq case (1999) and the Supreme Administrative Court of Finland (2013)²⁰. Although they are completely different jurisdictions, carrying out different activities in different other low-cost jurisdictions, it is the mechanisms that matters as it results almost in the same pattern: relocation of activities; realization of super profits; allocation of lower profits to the affiliated entity in the LCJ.

In the Compaq case, the relocation of manufacturing activity by the US Company Compaq to the affiliated entity Compaq Asia based in Singapore for cost savings purposes, due to the low wages. The method for the allocation of the rents was the cost-plus method with a markup on the costs, while partially allocating the net savings arising from low wages. The problem was that for cost purposes Compaq Asia was retained to be located in US, while should have been calculated according to the cost incurred in Asia. And this is what the Internal Revenue Service ruled, in order for the cost-plus method to be applied.

For the question if the partial allocation of location advantages could be accepted, the case progressed to the US Tax Court. Initially, Compaq allocated a percentage of the LSAs on top of the miscalculated markup, then it applied a CUP method to corroborate the remuneration. The data taken were from US uncontrolled suppliers in uncontrolled transactions. The Tax Court accepted it for two reasons:

- The reference market was the US since it is where the products were sold.
- Compaq Asia was the only manufacturer that could reach the Compaq's quality standards, therefore no adjustment was needed due to the lack of competition.

The other case concerns the Supreme Administrative Court of Finland dealing with location advantages, this time in a LCJ located in Europe (Estonia). It is important to notice that, the OECD Guidelines have been followed and affirmed in a ruling of a national Supreme Court, which constitutes an orientation jurisprudential principle in the forthcoming cases.

The dispute concerns OYJ, a Finnish parent company which had relocated some of its manufacturing activities to an affiliated company, AS, in Estonia. The remuneration was based on non- Estonian comparable, with a cost-plus method²¹. Because AS had specialized intangible assets, such as specific know how of manufacturing processes, the roster of companies which could substitute AS was ultra-limited. The Court decided in an increase of the markup of about two thirds, increasing the allocation of the profits to the party in the LCJ.

²⁰ Supreme Administrative Court of Finland Ct.4 Mar. 2013, KHO 2013:36.

²¹ For a detailed explanation including the percentages of the markup, see: M.Raunio, Supreme Administrative Court on Location Savings, 20 International Transfer Pricing Journal 4 (2013), IBFD Journals

CHAPTER 3: India

3. Overview.

To understand the view of the Indian tax authorities on the matter of location savings and LSAs in the transfer pricing context, it is necessary to understand the major rulings on the matter, plus the position in the revised India Chapter in the UN TP manual²². Concerning the internal regulation, a position on LSAs and Location Savings it is not explicitly found, neither in the Indian Income Tax act²³.

3.1 Indian Tax authorities position in the UN TP manual: Intangibles

The Indian Tax authorities' position has been showed in the submission of the UN TP manual chapter during its last revision. A brief review of the position on the matter of the Intangibles, since it is often taken in consideration in the following cases on Location Savings.

First focus of the tax authorities has been the treatment of intangibles, a focus that has been carried since the Chapter in the draft version of 2016²⁴. In chapter VI of the OECD, the Indian view asserts that the profits arising from and for the intangibles, shall be adequately allocated following the criterion of value creation. In the draft version of the TP manual, the complexities stated relate to the determination of the arm's length rate, due to the lack of comparable in the public domain²⁵. In my opinion, whereas tax authorities find it difficult to determine the rate of the transfer on the first pricing, will have a consequential effect for the determination of the super profit arising from location savings.

To bear in mind that the general overview of the Indian tax authorities is fairly aggressive, on the basis that the India as a whole market provide fertile field for MNEs to realize location savings: from skilled labor force to the access to the Asian market and its customer base²⁶. Hence, the tax authorities put forward the need for a correct transfer pricing that benefits the legal entities located in India. Another example of the aggressive stance is the treatment of the marketing of intangibles. This is why in the logic of the case, the view of the tax authorities have been confirmed after the judicial review, by the Indian judges²⁷. The creation and maintenance of marketing intangibles, creates also costs which are sustained by the taxpayers in India (e.g., subsidiaries) even when commissioned by affiliated entities outside India. The tax authorities therefore,

²² The work has been done on the UN TP Manual, Chapter 10, revision started with the Committee of Experts on International Cooperation in Tax Matters Twelfth Session Geneva, 11-14 October 2016 Agenda item 3 (b) (i) Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries.

²³ Indian Income-Tax Act, 1961

²⁴ The view of the marketing of intangibles, was taken by the authorities in relation with actions 8-13 BEPS and are reflected in the draft version of the UN TP chapter. See: Committee of Experts on International Cooperation in Tax Matters Twelfth Session Geneva, 11-14 October 2016 Agenda item 3 (b) (i) Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries, India Chapter.

²⁵ EY Global Tax Alert Library, News from Transfer Pricing, Intangibles, November 2016.

²⁶ S.Gosh, W.Shu, R.Tomar, Location Specific Advantages: India and China, International Tax Review, 2014.

²⁷ Maruti Suzuki Limited vs CIT [TS-595-HC-2015(DEL)-TP and Maruti Suzuki Limited vs ACIT [TS-93-SC-2010]

retain that adjustments have to be made, since it goes to the benefit of the entities outside the national borders.

3.1.1 (Follows): Location Savings.

As said before, it is in the interests of the entities and tax authorities in India, to have a better determination of the pricing of a transaction under the Arm's Length Principle. The same applies to Location Savings and their fair apportionment. This position is clear. What it is less clear, is how to quantify the benefits deriving from Location Savings, especially in the context of the lack of good local comparable.

As explained before in the BEPS approach, actions 8-10, it is the functional analysis that allows comparable entities and comparable transactions to serve as a base for the determination of the location savings between two affiliated enterprises. In line with this, in the India chapter, the need of a detailed functional analysis is stated, whereas there is to be determined the quantity of the savings. The position of the tax authorities on the availability of comparable, states that if they can be identified there is no need of an upward adjustment on location rents for the Indian located entities, provided they are realized, depending on the state of the competition. If there is a perfect competition environment, location rents may not be realized²⁸, as they are generally passed on to customers' benefits, in order to maintain the market share.

3.2 India and the BEPS.

The BEPS project is an important initiative of the OECD for combating tax avoidance strategies that take advantage of loopholes in the international legislation to shift profits in low-tax or no tax jurisdictions.

As mentioned before, India is not part of the OECD, but steadily cooperates in tax related issues for a better implementation of international tax standards.

It is useful to notice at the recent progression of the Indian implementation of the BEPS recommendation, since the release of the Action Plan in the 2013²⁹. In 2014 amendments have been made, trying to insert in the Direct Tax Code the Anti Avoidance rules and CFC (Controlled Foreign Provisions) provisions³⁰, which mirror the BEPS Actions 3 and 6. Although there is no CFC provision up to date in India³¹, a general anti-tax avoidance rule has been implemented after the 1st deferment in 2015³². In 2015, India signs the Multilateral Competent Authority Agreement (MCAA)³³, addressing the problem of off-shore tax evasion, having a

²⁸ R.K. Mitra, Revised India Chapter in UN TP Manual, Part II, Location Savings and Contract R&D services in focus, 2016, available at <http://www.tp.taxsutra.com/experts/column?sid=312>

²⁹ OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing.
<http://dx.doi.org/10.1787/9789264202719-en>

³⁰ It is referred here to the Income Tax Act 1961 which takes the major amendments from the Direct Tax Code (DTC). However, the whole new project of the DTC was dropped in 2015.

³¹ KPMG, India Tax Profile, 2018, page 5

³² Also known as GAAR, has been implemented on the 1st of April 2017 under chapter X-A of the Income Tax Act, 1961.

³³ Multilateral Competent Authority Agreement has been signed by 61 jurisdictions adopting the Standard on automatic exchange. See text: <http://www.oecd.org/ctp/exchange-of-tax-information/multilateral-competent-authority->

strengthened legal basis after having signed the Double taxation Avoidance Agreement (DTAA)³⁴ and the Tax Information and Exchange Agreements (TIEAs)³⁵, but especially the convention on Mutual Administrative Assistance in Tax Matters (MAAT)³⁶. The signing of these international agreements show that India is actively participating on the formal aspect of the exchange of the information between tax authorities whereas there are investigations to be conducted in the case of tax evasion³⁷. Concerning Transfer Pricing, the OECD issued a revision of the TP guidelines, in particular chapter VI is what will be discussed, since it deals with the location specific characteristics.

The action plan 8 of the BEPS follows the OECD guidelines, mainly Chapter IX³⁸. It deals with the transfer pricing of intangibles in the context of location savings. In particular, it is useful for solving issues arising from the sharing between two legal entities within the same group. The action plan in question, introduces a four step approach: 1) determination of the existence of possible locations savings; 2) determination of the amount of the savings; 3) their retention (or pass on, if the benefits arising are passed on customers); 4) the method used for allocating.

This approach can be used step-by-step and from case-to-case, but it is crucial to distinguish between two situations. The first is where comparable are available, which is the clearest, since it makes it easier to determine whether there is the allocation of location savings between related entities. The second situation occurs when comparable are not available. In this situation, given the lack of reliable data, it is possible to look at other factors, such as the type and number of assets used, the risk-benefit model used, the strategic approach and other elements that have been used in a similar way by an affiliated enterprise.

3.2 Indian Courts and location savings: the three major cases.

The following position of Indian Courts stem from the fact that the arm's length principle is the main point for the pricing determination³⁹. In the cases reported there are various issues faced by the Courts, which range from the methods of application of the arm's length principle to the implication of the economic ownership of intangibles?

3.2.1 The GAP case: location savings arising to the whole industry.

agreement.pdf

³⁴ The DTAA has been signed with 88 countries, although only 85 have been in force. Full text on: www.sircoficai.org/downloads/cpe-materials/Overview-of-India-US-DTAA.pdf

³⁵ Tax Information Exchange Agreements (TIEAs) agreed between India and third Countries are available at: <http://www.oecd.org/tax/exchange-of-tax-information/taxinformationexchangeagreementstieas.htm>

³⁶ OECD and Council of Europe (2011), The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: amended by the 2010 protocol, OECD Publishing. https://read.oecd-ilibrary.org/taxation/the-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters_9789264115606-en#page1

³⁷ Darren Rykers (2009): A Critical Analysis of how Double Tax Agreements can facilitate Fiscal Avoidance and Evasion; The Taxpayer and the Lotus, 17 Nov.2009.

³⁸ OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Chapter IX, Paris, <https://doi.org/10.1787/tpg-2017-en>

³⁹ For example in: Sony India Limited and LG electronics India (2013) Nos152 TTJ 273 (Del).

The GAP International Sourcing⁴⁰ ruling is a cornerstone on the matter of location savings. Here briefly the fact of the case. GAP India was end-tasked to facilitate the sourcing of apparel merchandise for the GAP group. On the basis of a procurement service, remuneration was on a cost plus fifteen percent base. The administration retained that the commission should account to five percent, and made an adjustment under the Arm's Length Principle. The tax authorities contested that, for the position of the taxpayer, that it was not just providing a simple procurement service, but it was creating a series of procurement intangibles⁴¹. Therefore the Indian Tribunal ruled that the consequent savings arise for the industry as a whole. Under the FAR analysis, it was rejected the claim that it was a low risk procurement service and, it was retained that GAP India should be the enterprise entitled to location savings, since due to the low cost services in India, it realized a super profit for the benefit of GAP US.

What the Indian Tribunal showed is that, the bargaining position of all the parties should in principle make a correct and fair apportionment among the transacting parties, under the Arm's Length Principle. It also pointed out that although the aim of sourcing from high cost countries to low cost countries serves as a strategy for MNEs to remain competitive on the global market, the advantage of location savings is passed on the end-customers through a competitive sales strategy.

The benchmarking to determine location savings must be done in the jurisdiction of the tested party through comparable, which are also useful to determine the existence of location savings when realized.

3.2.2 The Li & Fung Case: access to intangibles.

The main point in the Li & Fung Case⁴² concerns the allocation of profit shares between two transacting parties, of which one it is located in a low-cost country. The reasoning of the Delhi Court takes into analysis the importance of the intangible assets in relationship with the concept of bargaining power. The Court ruled that the access to intangibles for the owning party, gives a greater amount of bargaining power. Therefore it is consequential that the party that has the ownership of the intangibles, has a right to retain a bigger portion of the shares.

Concerning the method for the allocation, the Court deemed inadequate the cost-plus remuneration, indicating that, given the circumstances of the case, a return sales model would have been more adequate for a correct sharing of profits.

3.2.3 Watson Pharma Ruling: clarification on the use of comparable.

To explain in short the facts of the case, Watson Pharma Private Ltd was providing contract research and development services to the other affiliated enterprises of the group. For every transaction executed by the

⁴⁰ Income Tax Appellate Tribunal – Delhi: GAP International Sourcing v. ACIT, ITA Nos. 5147/Del2011 & 228/Del/2012, 19 Sep. 2012.

⁴¹ Case analyzed by Jain, P., & Chand, V. (2015). Location Savings: International and Indian Perspective. *Intertax*, 43(2), 192-198.

⁴² India vs. Li & Fung (Trading) Ltd. March 2016, ITTA

taxpayer, the compensation from the affiliated legal entities resulted in only the total operating cost plus arm's length mark-up base.

The Indian tax authority applied under arm's length principle, an adjustment for the location savings arising from the relocation of activities from USA to India. In the specific case, the tax authority had available data based on domestic articles, concerning similar transactions. Moreover, it followed the guidelines contained in the UN TP Manual.

The arguments against were that the selection of comparable made by the tax authority was based only on domestic data and that, the taxpayer was operating in a perfectly competitive environment and so, the eventual benefits arising from location savings were bound to pass to end customers.

The Court agreed in the last point to the reasoning, with the result that there was no super profit. Moreover, in the reasoning of the Court, in the presence of local comparable does not entail an adjustment, if the profit realized is in line with the level found in the same comparable.

In my personal opinion, this judgement shows how valuable the OECD TP Guidelines are for the best practices in analyzing the range of comparable. According to experts⁴³ the significance of this ruling lies in the fact that evidence of location savings were analyzed in a transfer pricing context and that it also shows the compliance of Indian Government to implement international transfer pricing principles and best practices.

3.3 Interim conclusion

As showed before, it is thanks to the international framework that it is possible to search for evidence in the quantifying of Location Savings and LSAs. As Chand pointed out⁴⁴, the simple calculations of the cost before and after relocation, is not completely reliable. There is still the need of multiple system interaction, for having even more precise guidelines in the determination process of LSAs and Location Savings. If not for the international guidance, the alternative is to check whether determined issues are dealt only the case law of specific jurisdictions. For example, on the share of the apportionment of location savings, the German judges in the Compaq case⁴⁵ ruled that if the Indian taxpayer has more bargaining power in reason of the quality, the tax administration may use the cost plus mark-up system under the arm's length principle. The problem in this case, is that this the reasoning of the German tax court, which circumscribed to the German jurisdiction, and has no effect if the view of the Indian Courts and Tax authorities does not match. Moving from the Pharma Watson Ruling, the international guidelines and transfer pricing principle, are being slowly internalized by the Indian system. Although it may be true, this is one of the aspects that shows a silver lining. The Indian government, as other government of developing Countries experiencing an increase

⁴³ Deloitte, Transfer Pricing Insight with information, No separate TP adjustment for Location Savings, Issue no: TP/2/2015.

⁴⁴ Jain, P., & Chand, V. (2015). Location Savings: International and Indian Perspective. *Intertax*, 43(2), 192-198.

⁴⁵ Compaq case analysed in: http://fitindia.org/downloads/Heinz_Klaus_Kroppen_2008.pdf

in relocation activities⁴⁶ , has the interest to tax the profits arising from LSAs, since it offers the optimal environment for relocation with all the advantages already discussed above. Since the OECD might not completely reflect the position explained, it is not possible to talk about a potential hardening of soft law⁴⁷, therefore, there is still a long way ahead for the reach of international transfer pricing standards.

⁴⁶ Of the BRICS country, on a similiar position can be found the China case

⁴⁷ N.K. Kuvailutiedot, Hardening of Soft Law: Implementation of Transfer Pricing Guidelines

CHAPTER 4: China.

4.1 Background: Chinese economy and transfer pricing landscape.

Along with India, China is an emerging economy, standing out for being the biggest economy in Asia per size. It shares in common the recent growth thanks to technological advancement and relatively cheap manpower, combined with strategic position in the East.

Considering China alone, the foreign direct investment indicator showed an increase of ten percent for each year⁴⁸, fostering also the exports on the balance of payment⁴⁹. Since the new millennium and some years before, it's Government put into place measures to increase the marginal rate of foreign direct investments: - from the tax perspective, new incentives to attract foreign companies such as tax holidays and tax reduction on profit⁵⁰ from the general legal system perspective the introduction of foreign investment protection laws. This favorable environment has attracted companies to the Chinese market, although as in every economy there might be spikes of highly profitable financial years to years where companies reported financial losses. What it does mean for foreign enterprises is that the taxable base is compromised, paying little to no taxes as it happened in the years from 1995 to 2001⁵¹. It is clear that, to enjoy the benefits of the presence in the Chinese market, companies started to implement transfer pricing practices playing with profits and losses, instead of withdrawal from the market. From tax avoidance to tax evasion⁵². One popular strategy was used from companies operating in the automotive industry, which consisted in artificially fixating the market price of the components of the single unit above the market average while shifting the extra profit to the parent company in a tax advantageous locations⁵³

In response to the abusive strategies, the Chinese Government reacted in two ways. The first, it strengthened the domestic legislation against the avoidance of taxation through profit shifting, such as the GAAR (General Anti Abuse Rules)⁵⁴. When binding the domestic legislation in international treaties, the Chinese Government cautiously inserted clauses like the LOB clause or the PPT clause⁵⁵. In the interpretation of the law, it also kept the concept of beneficial owner.

The second way has been the stipulation of treaties with several jurisdictions (more than one-hundred⁵⁶) that includes low tax rate or nil (fiscal heaven) like the British Virgin Islands. In this way it is possible to combat the practice of the interposition of an intermediary company (usually a cash box) to shift profits in one of the

⁴⁸ Trade and Development Reports, UNCTAD, years 2003. Available at unctad.org/en/docs/tdr2003

⁴⁹ Chan, K. H., & Chow, L. (1997). An empirical study of tax audits in China on international transfer pricing. *Journal of Accounting and Economics*, 23(1), 83-112.

⁵⁰ Sikka, P., & Willmott, H. (2010). The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness. *Critical Perspectives on Accounting*, 21(4), 342-356. Baker 2005, p. 144-146

⁵¹ Trade and Development Reports UNCTAD, years 2001-2005

⁵² Sikka, P., & Haslam, C. (2007). Transfer pricing and its role in tax avoidance and flight of capital: some theory and evidence. In *Centre for global accountability, seminar series University of Essex, UK*.

⁵³ Sikka, P, Haslam, supra.

⁵⁴ Li, Jinyan. "Transfer Pricing Disputes in China." *Resolving Transfer Pricing Disputes: A Global Analysis* (2012): 634-667.

⁵⁵ Xu, Diheng. "The Convergence and Divergence between China's Implementation and OECD/G20 BEPS Minimum Standards." *World Tax Journal: WTJ* 10.3 (2018): 471-496.

⁵⁶ SAT statistics in Xu, D., supra.

aforementioned jurisdictions.⁵⁷

It is seen in the following paragraphs how China cooperated in the international landscape with the international bodies and the projects on the global anti-avoidance initiative.

4.2 Transfer Pricing in China: the BEPS.

Even as a non-member of the OECD, China implements an arm's length approach as well as other definitions, in its domestic regulations⁵⁸. In fact art. 41 Enterprise Income Tax Law (hereinafter EITL) refers as to the principle adopted by unrelated parties when carrying out business transactions in accordance with fair market prices and common business practices.⁵⁹ For example the concept of related parties of the art. 109 EITL overlaps the definition of associated enterprises in art. 9 OECD TP Guidelines.

In regards of the BEPS, China has showed a positive attitude. For example the implementation of the anti-abuse provisions recommended in actions 6-7 BEPS, in the treaty between China and Chile limiting the benefits of a reduced withholding tax⁶⁰.

BEPS actions 8-10 and actions 13 are the main point where, there might be divergence with the views of China and the OECD. Actually the purpose is common to both parties: align transfer pricing outcomes with value creation. But, given the peculiarities of the Chinese market and China as a whole, China states that the axis between the pricing and the value creation do not align, for a series of advantages enjoyed by the foreign MNEs. These are the LSAs that consist in LSs and Market premiums. Of the former it has been discussed before (see Chapter 2). Of the latter, the market premiums are extra profits, derived by favorable conditions, in a determined market, of a specific location. For example, in the Luxury goods market, the love of Chinese customers for foreign brands, is reflected in the high demand, which allows sellers to set a higher price than the one found in the market of origin (production)⁶¹.

If the transfer pricing output is not aligned with the value production, the consequent tax base will be eroded, damaging Chinese budgetary dynamics. In the following paragraph the specifics stated by China in the UN Manual.

⁵⁷ McLure, C. (2006). Transfer pricing and tax havens: Mending the LDC revenue net. *The Challenges of Tax Reform in the Global Economy*. Berlin: Springer-Verlag.

Specifically for China: Ives, J. M. (2017). The relevance of tax havens for China.

⁵⁸ Markham, M., & Liao, Y. (2014). The development of transfer pricing in China. *Austl. Tax F.*, 29, 715.

⁵⁹ It represents the view stated in the discussions of the TP Guidelines concerning the arm's length principle.

⁶⁰ China-Chile Treaty.

⁶¹ On the Chinese Love for European Designer Handbags and Lower Production Costs in India International - The Impact of Location Advantages on the Transfer Pricing of Multinationals: On the Chinese Love for European Designer Handbags and Lower Production Costs in India Martijn A. de Lange and Paul W.H. Lankhorst Vol. 21 Issue: International Transfer Pricing Journal, 2014

4.3 Location specific advantages: UN Manual

Concerning LSAs, the definition itself is contained in the Chapter 10⁶² on Country Practices of the UN Manual. The SAT, referred in the Chapter LSAs include LSs, marketing intangibles and market premiums. in the Chinese TP landscape they tend to manifest as LSs and Market Premiums.

About LSAs it has already been discussed in what they consist of. Perhaps the problematics are precisely defined in the chapter as: 1) identification (whether location savings exists); 2) determination of profit; 3) quantification of profits; 4) determination of transfer pricing method.

As for these problematics, the so-called four step approach has been implemented in the Chapter as a guide for determining any LSAs. Briefly they are

- identify if a location-specific advantage exists;
- determine whether the location-specific advantage generates additional profit;
- quantify and measure the additional profit arising from the location-specific advantage; and
- Determine the transfer pricing method to allocate the profits arising from the location-specific advantage.⁶³

Although this guidance has been provided, in the same chapter⁶⁴, the following issues are addressed:

- There is shortage of reliable comparable as public companies are relatively a small group. The fact of using foreign companies as a source of data is inadequate due to obvious differences between the companies situated in developing and the ones operating in developed Countries. If compared under a transfer pricing perspective, there must be an adjustment. LSAs are difficult to account for in the two industries mentioned in the chapter (automotive industry and contract and research development)
- In light of the above there is a substantial problem with the adequate pricing method. China mainly relies on the arm's length principle. The most popular and the most aligned method used with consequent adjustments is the Transactional Net Margin Method (TNMM). The profit split method also, is suggested for different kind of businesses, like the electronic manufacturing enterprises.

When determining the profits, a more holistic approach is invoked Concerning LSAs, Chinese entities are in principle entitled to additional profits due to the exploitation of cheap labor and highly skilled workforce (research talents) through contract manufacturing and contract research services. Foreign companies take comparative advantages such as cheap labor or natural resources or research talents and so on in the form of contract manufacturing and contract research services. It is peculiar the example of the marketing intangibles for the determination of profits. Chinese entities endowed with intangibles may be entitled to additional profits, on the presumption that the intangibles can be improved over time and creates extra values resulting in extra profits, when used in the Chinese

⁶² UN Manual, *Practical Manual on Transfer Pricing for Developing Countries*, 2010, Chapter 10.

⁶³ W. Guo et al., Corporate Loss Utilization through Aggressive Tax Planning, 20 Intl. Transfer Pricing J. 1 (2013), Journals IBFD, p.3

⁶⁴ UN Manual, China Chapter.

market.

As an addendum, according to China the expansion of statute limitation can help solve some TP issues for developing countries, along with clearer rules on TP documentation and penalties...⁶⁵

4.4 SAT, Bulletin 6: impact on intangibles and LSAs

The SAT Bulletin on the Administrative Measures for Special Tax Investigation and Adjustments and Mutual Agreement Procedures was issued on the 17th March 2017, as part of the domestic regulation adding to the Enterprise Income Tax Law. Since it is part of the latter, it is not clear if it has effect from the date the EITL was effective (1st January 2008) or the date the bullet came into effect.

The scope of the bulletin includes any MNE engaging in a cross-border, related-party transaction involving China, with the exception of transactions between domestic related parties that are part of a group are, given that the tax revenue due to the Government would not be decreased.

The bulletin confirms some positions adopted by the SAT, and for the current discussion, only the impact it had on the intangibles and LSAs related issues are treated.

Following the BEPS actions 8-10, it states that the method of allocation for the determination of profits deriving from intangibles is the value contribution analysis, relying on the DEMPE (Development, Enhancement, Maintenance, Protection, Exploitation criteria) plus marketing contribution. The reason is given by the SAT view that marketing and sales activities is part of the value creation of intangibles. Plus, it is an official SAT rule that any legal owner who does not contribute to value creation shall not receive any return from the intangible.

Concerning LSs and Market Premium requires LSAs analysis in comparability analysis, with the potential consequence that there might be an adjustment after the analysis only based on LSAs.

There is a big plus considered by the SAT in the matter of LSAs. Starting from the automotive industry, which highlighted the favourable conditions of the market, with high demand and low cost of production, any related extra profit is attributable to the Chinese entities. Now these logic has been applied by the SAT to other industries.⁶⁶

4.5 Conclusion

The issue of Location Savings has been addressed in literature by Chinese scholars. It has been done either analyzing the view of the Chinese tax authorities, which have a clear and direct position on LSAs in tax assessments; either with domestic legislation.. The view mentioned above is stated by Chinese Tax Officials in chapter D.2. of the UN Manual, China Country Practice and as seen by the SAT in Bulletin 6 . The tax administration addresses equally issues of location savings and market premiums framed in the picture of transfer pricing.⁶⁷

⁶⁵ China (People's Rep.); UN - Views on transfer pricing issues (27 Dec. 2012), News IBFD.

⁶⁶ C. Chi, R. Triginelli Miraglia & A. Wang, China (People's Rep.) - Transfer Pricing & Dispute Resolution, Topical Analyses IBFD

⁶⁷ C. (X.) Peng, A Rethink of Location-Specific Advantages with an Analysis of the Chinese Approach, 24 Intl.

- It has also been discussed the market conditions, allowing China to act as a fertile ground for LSAs, Market Premiums and Location Savings and their realization. In fact companies view China not only as an open end market for goods and services, but as a potential value storage for R&D activities. This means that the attention towards intangibles and transfer pricing grew over the last decade. When comes to transfer pricing investigations to determine at arm's length the value of the transactions, it often involves intangibles as object of related-party transactions: from all range of services connected to technology, marketing intangibles; and new to the transaction history, capital thinning and business valuation for related-party equity transfers⁶⁸

- In literature, the fundamental view of China in regards of BEPS is negative⁶⁹, as it considered to be unfair because China wants its legitimate fair share⁷⁰. This because of the mismatch between the location of attributable taxation rights and the exertion of substantial economic activities. The logic is: whereas the government creates the optimal business environment, from which the aforementioned advantage are given to companies, the right to tax business profits is undeniably prerogative of that jurisdiction⁷¹. As a consequence cost savings and market premiums derived from operations in specific localities should be imputed to the subsidiaries present in this locations, blocking the flowing back to the parent company.

- The China Chapter delivers a specific approach to the treatment of intangibles and deriving LSAs. The examples discussed consist in a four-step analysis and a numerical example which follows the 2012 version. An increase in the cost mark-up is inversely proportional to the difference between the cost base of the Chinese taxpayer and the average cost base of the foreign affiliated entities. In literature it has been reported that varying system profits can benefit the Chinese economy, because it is transitioning from production-based to consumption-based, and is generated by extensive marketing expenditure in China in order to attract foreign customer and strengthen the brand image. In the Chapter it is also addressed the issue of secondary marketing intangibles with related incremental profit, realised by heavy marketing expenditure in the local market. Also consideration of additional means to compensate local subsidiary for carrying out economic activity, like the revaluation of royalties paid to the parent company, which may be too high given the present time⁷². To recapitulate and conclude this part, the author sums the view of the Chinese Tax Authority or SAT (State Administration of Taxation). The SAT aims to identify and retain deriving profits from LSAs, Location Savings and Market Premium, putting forward that it is legitimate to tax these profits as they are localized in the Country territory and there carry economic activity. The SAT wants to prevent these profits to flow to the parent's company home country and to tax havens, losing the opportunity to tax in toto. The SAT has adopted the four step approach to prevent this situation: identify the existence of the advantage, determine if it generates an economic rent, quantify profits, allocate the profits arising to the parties. It gives high

Transfer Pricing J. 6 (2017), Journals IBFD

⁶⁸ B.A. Norwood, Location Savings and Other Location-Specific Advantages, 19 Asia-Pac. Tax Bull. 5 (2013), Journals IBFD

⁶⁹ J. Li, China and BEPS: From Norm-Taker to Norm-Shaker, 69 Bull. Intl. Taxn. 6/7 (2015), Journals IBFD

⁷⁰ Glenn DeSouza, 'What the UN Manual Really Means for China?' Intertax, Issue 5, pp. 331–338, 2013

⁷¹ J. Li, China and BEPS: From Norm-Taker to Norm-Shaker, 69 Bull. Intl. Taxn. 6/7 (2015), Journals IBFD

⁷² R. Triginelli Miraglia, M. (Mimi) Wang & C. Chi, The New China Country Practice Chapter of the UN Practical Manual on Transfer Pricing: Reflections on Post-BEPS Transfer Pricing in the Middle-Kingdom, 23 Asia-Pac. Tax Bull. 4 (2017), Journals IBFD

attention to intangibles, including advertising, marketing and promotion. These profit generators must allocate extra profit ⁷³to China or not deduct the excessive expenditure. It is preferable to identify these volumes of profit with either a profit split method and/or comparability adjustments when the transactional net margin method (TNMM) is used for determining the transfer price⁷⁴. These consideration need to be taken into account also when dealing with potential loss making in China, not only generation of plus profits. The SAT has declared that recognizes the existence of LSAs imputed to China's unique market qualities.

⁷³ S. Yuan, J. Liu & G.R. DeSouza, Changing Transfer Pricing Landscape: "Like It or Not", 20 Intl. Transfer Pricing J. 4 (2013), Journals IBFD

⁷⁴ W. Guo et al., Corporate Loss Utilization through Aggressive Tax Planning, 20 Intl. Transfer Pricing J. 1 (2013), Journals IBFD

CHAPTER 5:

Similarities and Differences on transfer pricing and location savings policies.

5.1 Alignment of the OECD Transfer Pricing policies with the internal measures adopted by India and China.

After having described the general framework concerning the legal instruments of both India and China and, their relationship with the international bodies, each playing a role in the shaping of international tax landscape. The author will answer to the question, displaying similarities between the two jurisdiction, of whether the Indian and Chinese policies can converge.

To answer this questions it is needed to repeat and confirm the main objectives that has charchterized the OECD policy around the arm's length principle, and to see if they match the same put in place by the two Countries in question.

The ALP serves the dual objective of securing the appropriate taxable base in every jurisdiction and avoiding double taxation.⁷⁵ This means that when evaluating an international transaction, every element of business income needs to be considered to determine the taxable base. In the opinion of the author location savings fit this view, as it will be seen, either for a correct calculation of the taxable base, either for the avoidance of double taxation.

In second place, all the parties in a transfer pricing transaction, in good faith, should reach for the consistency in every transfer pricing transaction, to the arm's length principle⁷⁶.

As non-member of OECD Countries, the author believes that both policies of India and China aligned with the common objectives stated, nonetheless the specific conditions which hinder developing Countries in the international transfer pricing policy. This motive alone shows the good faith of the two Countries in willing to co-operate in a non-conflictual way. considered that the OECD should also tend to give highlights to the claims being invoked by the taxpayers to pursue the goal of the global economic development.

5.2 Alignment by common interest in taxation: source taxation.

As Countries with an high foreign investment rate China and India share a common interest in pursuing source taxation. Source based taxation imposes a model of taxation in accordance with the territoriality principle and sovereignty principle, as the “source Country” holds taxing rights over a taxable subject.⁷⁷ Applied to the context of outsourcing to developing Countries⁷⁸, a taxation model based on the source

⁷⁵OECD, Transfer Pricing Guidelines, 1995-2017. It is starting from the 1995 that the first mention of the dual purpose has been explicitly stated. See Preface, paragraph 7.

⁷⁶ OECD, Transfer Pricing Guidelines, *supra*, paragraph 2.2: “*should endeavour to make a good faith showing that their determinations of transfer pricing are consistent with the arm’s length principle regardless of where the burden of proof lies*”.

⁷⁷L.U. Cavelti, C. Jaag & T.F. Rohner, Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD's Actions against Base Erosion and Profit Shifting, 9 World Tax J. (2017), Journals IBFD

⁷⁸A. Báez Moreno, The Taxation of Technical Services under the United Nations Model Double Taxation Convention: A Rushed – Yet Appropriate – Proposal for (Developing) Countries?, 7 World Tax J. (2015), Journals IBFD

taxation principle benefits those Countries whereas the economic activity is carried out, in the meaning that taxation reflects the actual geographical location of the value produced. India has been an advocate of source taxation⁷⁹. In fact looking at the logic of *Indian treaties, the main aim to obtain more taxation rights based on the source in respect of the ones granted by the OECD Model Convention*.

Data that confirm this affirmation can be found in the tax treaties stipulated with OECD and non-OECD Countries. Example include: Dividends paid to a foreign, dividends paid to a foreign portfolio holder, payment of royalties⁸⁰

In China as well, beyond the previous example, it is possible to show a strong tendency to the application of source taxation model in regards to fees on technical services for foreign entities carrying out a project in China, which are deemed to have a taxable establishment there⁸¹.

Since outsourcing projects by MNEs are carried out in LCJs in order to gain the benefit of the low cost of productions, plus the LSAs analysed before, a source taxation model reflects the interest from LCJs to tax the value creation where it is produced. This approach followed by both Countries is inherent to the dynamics of transfer pricing and the search from MNEs of the optimal location for production, also in terms of taxation benefits. Having a similar background, helps to conceptually frame a stand where the two Countries share a common nature, a starting point for their policies to converge and follow the same interest. Further, the author believes that in some cases, the output in tax policy by both India and China administrations, goes beyond the mere passive co-operation, but it becomes proactive. Following the specific examples.

5.3 Mirroring the OECD approach in Transfer Pricing.

China met and went beyond the meeting of the minimum requirements, through the SAT tax policy, which released a series of internal measure for the interpretation of existing concept in conformity with the BEPS or created new ones, for example in obtaining comparability information for the unconventional pricing factors⁸². The SAT implemented the value chain analysis for location savings and LSAs for the Advanced Pricing Agreements before the filing stage.⁸³

With Circular number 6 it made official that the ALP as the guiding principles for the intra-company transactions and following adjustment, while for location savings retained that the only use of local

⁷⁹ J. Hey, "Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative, 72 Bull. Intl. Taxn. 4/5 (2018), Journals IBFD

⁸⁰ The following treaties have been concluded by India with Austria, Belarus, China, the Czech Republic, Finland, Ireland, Jordan, the Kyrgyz Republic, Morocco, Namibia, Portugal, the Russian Federation, Qatar, Trinidad and Tobago, and Ukraine. It is possible to find the aforementioned policies concerning source taxation in detail in:

IFA Cahier 2005, Volume 90 A, India on:

https://research.ibfd.org/data/ifacahier/pdf/ifacahier_2005_volume1_australia_.pdf#ifacahier_2005_volume1

⁸¹ Edwin van der Bruggen, Source Taxation of Consideration for Technical Services and Know-How with Particular Reference to the Treaty Policy of China, India and Thailand, Asia Pacific Bulletin, 2001

⁸² J. Li, *International Taxation in China: A Contextualized Analysis* (IBFD 2016), Online Books IBFD.

⁸³ CN: SAT, Announcement of the SAT on the Issues Concerning Improving the Administration of Advance Pricing Arrangements, Bulletin No. 64 [2016] (11 Oct. 2016).

comparables can also be sufficient for the calculation of location rents, serving also as an effective measure for the lack of comparables. China increased transparency (in line with the OECD call of action for transparency in the context of tax information) through the provisions on CbC reporting, since the SAT requires additional information on the MNEs transactions⁸⁴ (Bulletin No. 42). The implementation of the BEPS Actions 8-10 and 13 Final Reports transfer pricing rules implies that China is adapting the OECD recommendations to its own circumstances. China approach to LSAs other than providing a singular approach to the value creation method⁸⁵ solves the problem of double taxation, through the single entity approach. As opposed to the separate entity approach which characterize the policy of the OECD, the Chinese MNE-related entity benefits individually from the profit arising to the entities group, which means that profit arising from LSAs would be allocated to the single firm⁸⁶ and are consequently taxed in the source state. It also responds to the profit shifting practice that moves profit away from Chinese entities, which remain most likely not taxed.

This is a commendable solution from the Chinese Government, which can be taken in account from the OECD.

As an Interim Conclusion and in the lights of above the answer to the first part of the research question is affirmative. Both China and India have responded to the OECD policies in a similar and comparable way.

5.4 India and China and the approach to location savings, conciliation?

The claim that the arising profits should be allocated to the low-cost State is common to both India and China, based on the reasons above analysed.

India e Indian tax administration has sought to allocate high mark-ups to captive Indian service centres by characterizing the Indian affiliate as ‘high value’ or ‘high end’ service providers that generates significant location savings to the MNE group. China on the other hand.

The author will further analyze how the two Countries responded to location savings issues, for the purpose of comparison. India has showed a two-fold evolution on the answer for location savings: one is through national judicial rulings (Li&Fung, Watson Pharma, GAP International), the other in the full expression of the SAT in the UN Manual. Although the two different approaches to the same problem, it has been seen that the result from the cases cited are more in line with the OECD BEPS. This because in the case X, Y, Z. China on the other hand has more steadily showed the counter opposition to the BEPS and the internal resolution through the emission of internal measures (Bulletins) is coherent with its claim and opposition line.

The author thinks this is a noticeable difference in the ways of responding to the policies, which would in principle trace, the foreseeable line of approach by the two Countries. Nonetheless, the sewing thread is the

⁸⁴ OECD, *A New Boost to Transparency in International Tax Matters: 6 New Countries Sign Agreement Enabling Automatic Sharing of Country-by-Country Reporting* (12 May 2016)

⁸⁵ Value Creation Method definition in: J. Hey, “Taxation Where Value is Created” and the OECD/G20 Base Erosion and Profit Shifting Initiative, 72 Bull. Intl. Taxn. 4/5 (2018), Journals IBFD

⁸⁶ J. Li & S. Ji, *Location-Specific Advantages: A Rising Disruptive Factor in Transfer Pricing*, 71 Bull. Intl. Taxn. 5, p. 271 (2017), Journals IBFD.

claim of the taxpayers, which will not possibly change overnight, as the allocating measures invoked are common to both Countries.

In both Countries it has been contested the application of the distributive method of profits. The ideal mechanism for India would be, relying on local data comparability, directly apportion the location rent with the Comparable Uncontrolled Price method. Alternatively, a Transactional Margin Method would be appropriate. Also in China, the use of the TNMM has been widespread in the TP documentation, even if the SAT criticized this method as been overused.

The problem in both Countries is the lack of comparables in specific industry sectors, therefore it has consequences on the appropriate method of allocation. In India, the use of the Cost-Plus method has been retained inadequate in allocating the fair share (location rent), whereas the Profit-Split method has been useful for determination of profit relating to intangibles related operation. In China, as a way to resolve the impact of the lack of comparables on the distribution method, with the draft revision of Circular n.2⁸⁷, it has been proposed the value contribution method, which focuses more on value creation factors', the roles of these factors in the contribution to the parties'. This way it is possible to reach for a fair allocation of profits. Both countries have tried to adjust for the shortcomings of the arm's length principle, with alternative methods for profit attribution.

In China it has been discussed whether a formula apportionment would balance out the negatives of the equation resulting from the application of the arm's length principle to the context of developing Countries.⁸⁸ For now, the admirable work of the SAT, in the willing of opting for an adaptation of the arm's length principle, shows the good will of the Chinese Government to contribute to the shaping of the international taxation landscape, even if outside the OECD.

A similar approach in the tax policy has been also followed by the Indian Government, with the difference that it has granted more flexibility for the taxpayer under the pricing determination. In fact it included a sixth provision along with the five traditional TP methods, under the wording of "any other method" as an alternative. The conditions are associated with the price, comparability of the entities and the nature of the transactions as firm points, respecting the rules under arm's length.⁸⁹ The author defines it as flexible because no method has precedence over another one and in the case of a determination of more than one pricing in the transaction (of which the first choice is given to the taxpayer), the mathematical average shall determine the final outcome. Also this example shows a positive attitude on the implementation of the ALP mirroring the whole OECD policy.

⁸⁷ Y. Dong & B. Kaur, The Potential Effect of Action 4 of the OECD Base Erosion and Profit Shifting Initiative Regarding Excessive Interest Deductions on Companies in Asia, 73 Bull. Intl. Taxn. 1 (2019), Journals IBFD

⁸⁸ D. (Diheng) Xu, The Convergence and Divergence between China's Implementation and OECD/G20 BEPS Minimum Standards, 10 World Tax J. (2018), Journals IBFD.

⁸⁹ The Central Board of Direct Taxes prescribes these conditions relating to an international transaction namely: the method shall consider that the price charged would have been similar to an independent uncontrolled transaction., under similar comparable circumstances and within non related entities. See: Rule-Income tax rule, No. 10 AB, Transfer Pricing Methods, Section 92C, available on: <https://www.incometaxindia.gov.in>

CHAPTER 6:

Recommendation and Conclusion

6.1 Recommendations.

Following the debate of whether a developing country should or should not follow the OECD guidelines in TP matters, the author is of the opinion that it is possible and advantageous. India and China constitute an example of possible and positive cooperation. This because the alignment in objective and interest cannot be anything but natural, since the States aim to safeguard their tax base against abusive profit shifting practices. Also, a developing Country should avoid as much the overuse of tax benefits for foreign entities, such as extended tax holidays, because MNEs can easily take advantage in international tax planning for the timing needed to its interest⁹⁰.

Concerning the lack of comparables, a huge problem has been and is, the lack of comparables for the determination of the correct pricing. To bear in mind that developing Countries databases need to contain different type of data concerning MNEs and their transactions with affiliated entities, based on the nature of the entity and its geographical area of operation. The sense the author wants to give is that comparable entities within developed and developing Countries are in principle not comparable, since the conditions of their development, meant as the economic environment in which they grew, differs greatly from one HCJ to another LCJ. Also, when comparing uncontrolled transactions with independent entities, the latter can vary greatly from the structure of an MNE of a developed Country, in terms of organization, corporate structure, output activities.

Furthermore, when choosing comparable data for evaluation purposes, the author is of the opinion to exclude data that causes disruption compared to the national ones. In the case of China for example, it is useless to use Japanese comparables⁹¹ for two orders of reasons:

- The first and most obvious, Japanese is a developed Country. It is not clear the reason of why the use of such different standards;
- Second, following the reasons above, the nature of a foreign MNEs from a developed Country is problematic enough, if to this it is added the fact that third foreign subjects are already different in the structure of the organization the comparison is even more problematic

A solution can be the enhanced co-operation of tax administration of developed Countries, if they would agree in sharing of information stemming from databases, exporting data to the tax administration of developing Countries⁹². This is way it is easier to determine the correct pricing under ALP and compute if a location rent from LSAs arises. To be coupled with the disclosure of third-party data on the transactions through access to OECD Countries databases, in line with the principle of co-operation between the tax

⁹⁰A good example of a developing Country that matches the above criteria is Chile. See: *International - The UN Practical Manual on Transfer Pricing for Developing Countries: L.G. Ablet, Should It Depart from the OECD Transfer Pricing Guidelines?* IBFD, 2017

⁹¹ G. De Souza, What the UN Manual Really Means for China? 41 *Intertax*, Issue 5, pp. 331–338

⁹²T. Falcão, *Contributing a Developing Country's Perspective to International Taxation: United Nations Tender for Development of a Transfer Pricing Manual*, 38 *Intertax* (2010), 504

administrations. If data are available to the tax administration, it would be easier to determine the pricing in an international transactions involving a foreign MNE affiliated entity, on the basis of third entities concluded transactions in specific sector.

A limit to this approach would be the need of the State to protect sensitive governmental data, involving financial transactions. Data protection in fact, could limit the exchange of information because of two reasons:

- the amount of data involved in disclosure can be easily quantified as big data, with all the consequences involved for processing;
- the co-operation between the tax administrations involve sending data to a foreign Country, which shall according to the current European Data Protection Laws, grant an adequate level of protection to the data object of the transfer.

However the author retains the exchange of information possible, since the data involved are non-personal data. Personal data are data that can be linked to an identified or identifiable subject according to art. 2 of the General Data Protection Regulation. From the scope of this Regulation, corporate data and VAT data are excluded. In EU, the definition of privacy generally refers to the law to keep your own affairs confidential.⁹³ Privacy has become more important in the European Court of Justice case law. The meaningfulness of tax data under a data protection perspective has been ruled in the Bara case. Where it has been highlighted how tax data need safeguard for protection comparable to the ones on personal data⁹⁴

In case of a data transfer between tax authorities, some articles⁹⁵ should be interpreted as precluding national measures such as those at issue in the main proceedings, which allow a public authority of a MS to transfer personal data to another public authority for subsequent processing, without the data subject being informed of that transfer or processing. However the author believe also that, as far as it concerns the OECD European Members, international agreements can be concluded between developed EU Countries and developing Countries.

6.2 Conclusion.

For the purpose of this thesis, the author hopes it has made clear what are the current policies being implemented by India and China, in TP matters, in particular location savings.

It finds positive that as observers and non members of the OECD, they are actively responding and implementing, arguably with or without success, the guidelines in transfer pricing context. It is clearly a show of good faith in a way that allows a clear interaction and opens further dialogue for the future, since the BEPS project will have a long-term impact in transfer pricing in Asia⁹⁶. The adoption of General Anti Avoidance Rules in the internal legal system, is also showing that both India and China, in relation to the OECD recommendation, share the same goal of anti-tax avoidance against base erosion.

⁹³ F. Debelva & I. Mosquera, *Privacy and Confidentiality in Exchange of Information Procedures: Some Uncertainties, Many Issues, but few Solutions*, *Intertax* 2017 Volume 45, Issue 5, p. 363.

⁹⁴ "Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data" [1995] OJ 281.

⁹⁵ Arts. 10, 11 & 13 of the Data Protection Directive

⁹⁶S. Sim, A Different Take on Transfer Pricing in Asia, 22 Asia-Pac. Tax Bull. 4 (2016), Journals IBFD

Relating to location savings, even if challenges remain, is positive also to notice that the demand of the taxpayers are also on the same ground. The slight discrepancy which can be noted, is the alignment of the Indian Courts with the BEPS, of which might see to distance from the view of the Chinese SAT.

About remaining challenges it is noteworthy to cite:

- Comparable data are still unadequate, especially relating to uncontrolled transactions.
- Tax authorities alone are striving for solving all the problems relating to transfer pricing, however without increasing the capability it is not possible for them to act as a cure for all the illnesses.

The OECD Countries need to increase co-operation, also in delivering concrete solutions and substantial help as the database info sharing related to third-party transactions, meaning that the OECD guidelines should not serve only as a lighthouse for internal situations. They need to serve the final purpose of the OECD, which honouring its own nomenclature, need to foster the global economic environment, giving weights also to the needs of developing Countries.

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¹Edwin van der Bruggen, Source Taxation of Consideration for Technical Services and Know-How with Particular Reference to the Treaty Policy of China, India and Thailand, Asia Pacific Bulletin, 2001

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