DOUBLE IRISH DUTCH SANDWICH AND THE INDIAN TRANSFER PRICING LAW

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ABSTRACT

Tax avoidance is something that has existed since the very concept of a paternalistic state and the need for levying taxes was introduced in the fabric of modern day societies. A slight reduction in the percentage of tax payable can cause a remarkable increase in the profits of a business enterprise and thus, taxpayers always find some way or the other to reduce their tax liability. In recent years, some of the biggest multi-national corporate giants including Apple and Facebook have been able to drastically reduce their tax liability by shifting their incomes from high tax jurisdictions to countries where the rate of taxation is minimal. One of the novel ways used by these giants to hoodwink national governments and avoid tax is what is now popularly called as the Double-Irish-Dutch Sandwich.Since, a lot of academic ink has not been spilled on the subject; this paper tries to contribute to the existing Transfer Pricing Jurisprudence in two ways. First, it tries to explain the background for a better understanding of the issue. Second, it will elaborate and analyse the various arguments that can be adduced from the assessee and the revenue and argue for reforms. The paper is divided in five parts. The first part delineates the Double-Irish Dutch structure briefly. The second part explains the various methods for calculating the arm's length price under Section 92C of the Indian Income Tax Act, 1961. The third and the fourth parts expound the various arguments that can be put forward by the revenue and the assesse respectively, and the final part concludes the paper by arguing for some reforms in the existing legal framework related to Transfer Pricing in India.

1. INTRODUCTION

Tax avoidance is something that has existed since the very concept of a paternalistic state and the need for levying taxes was introduced in the

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fabric of modern day societies. A slight reduction in the percentage of tax payable can cause a remarkable increase in the profits of a business enterprise and thus, taxpayers always find some way or the other to reduce their tax liability. In recent years, some of the biggest multi-national corporate giants including Apple and Facebook have been able to drastically reduce their tax liability by shifting their incomes from high tax jurisdictions to countries where the rate of taxation is minimal. As news and reports of various tax avoidance strategies adopted by these multi-national giants became public, an intense public debate to curb the same was triggered, which has brought the issue to the zenith of the international tax policy agenda.[1]One of the novel ways used by these giants to hoodwink national governments and avoid taxes is now popularly called as the *Double Irish Dutch Sandwich*. The author, with the help of this paper, has tried to explain the problems created by this arrangement and analyse whether or not the Indian Transfer Pricing Law is equipped to adequately deal with the same. Since, not a lot of academic ink has been spilled on the subject, this paper contributes to Transfer Pricing jurisprudence in two ways. First, it will try to provide a background for a better understanding of the issue. Second, it will elaborate and analyse the various arguments that can be adduced from the assessee and the revenue and argue for reforms.

The article is divided into five parts. The first part briefly delineates the *Double Irish Dutch Sandwich* as used by multi-nationals to shift their incomes from high tax jurisdictions to low tax havens. The second part deals with explaining the various methods of calculating the arm's length price in international transactions between related entities under the Indian Transfer Pricing Law. Various arguments that can be adduced by both taxing authorities and the assessee are explained in the third and fourth parts and the author's conclusions and suggestions are given in the last part of the paper.

2. DOUBLE-IRISH DUTCH SANDWICH: THE STRUCTURE

[1] Clemens Fuest et al., *Profit Shifting and 'Aggressive' Tax Planning by Multinational Firms: Issues and Options for Reform*, Discussion Paper No. 13-044, available at http://ftp.zew.de/pub/zew-docs/dp/dp13044.pdf(last accessed on 26 August 2015).

The tax planning strategy that Google, Apple and many other multinationals use to reduce their tax liability has become famous as '*Double Irish Dutch Sandwich'*. As the name suggests, the structure involves two companies incorporated in Ireland, one company holding Intellectual Property Rights and one Operating Company, and one Conduit Company established in the Netherlands. For a better understanding of how the entire structure works, let's assume that Elixir India is a major pharmaceutical company which manufactures drugs based on the traditional Ayurvedic knowledge in India. A newly formulated drug which was developed by the company in India after incurring heavy expenses in its research and development can help it make a windfall. The company however, creates a wholly owned subsidiary in Ireland (Elixir Ireland 1) and licenses the Intellectual Property Rights (hereinafter referred to as **'IPRs')** to this company at a Cost-Plus Mark-up price, since Ireland is a very suitable destination for holding intellectual property assets due to Ireland's favourable tax regime for IP holding companies. Though this company is incorporated in Ireland, it is controlled from Malta and thus, for Irish tax purposes it is a Maltese company. Now, Elixir Ireland 1 creates another subsidiary (Elixir Netherland) and licensed the IPRs on the new drug to this new formulated company. Elixir Netherland in turn creates another subsidiary namely Elixir Ireland 2. It is Elixir Ireland 2 which exploits the IPRs, manufactures and sells the new drug, thereby making huge profit. However, since it was wholly owned by Elixir Netherlands, the company transfers 99% of its profits to the latter as royalty which in turn transfers them to Elixir Ireland 1. This whole arrangement leads to huge tax savings for the company for a number of reasons. First, since Malta does not impose any tax on its corporations on royalties received from patents, copyrights and trademarks,[2] Elixir Ireland 1 does not have to pay any tax. Second, Elixir Netherland helps the company to avoid the withholding tax that Ireland imposes on foreign companies. Since, there is a tax treaty between Ireland and Netherlands, the company does not have to pay any withholding tax. Finally, since there are no withholding taxes under the Dutch law, Elixir Netherlands can transfer all its profits to Elixir Ireland 1 (which is a Maltese company) without

[2] Jeffrey Rubinger and Summer Ayers Lepree, *Death of the "Double Irish Dutch Sandwich"? Not so Fast*, available at http://www.taxeswithoutbordersblog.com/2014/10/death-of-the-double-irish-dutch-sandwich-not-so-fast/ (last accessed26 August 2015)though the Irish Finance Minister recently proposed reforms that would cause corporation incorporated in non-resident corporations to be taxed as resident firms, the reform proposal is not enough to end the Double-Irish Dutch Sandwich because of the various treaty obligations that Ireland has with several low tax jurisdictions.

paying any tax. The matters can get worse if an Advanced Pricing Agreement was signed by the assessee and the revenue.[3]

While the structure appears legitimate at first and the transfer of IPRs by the Indian company to its Irish subsidiary seems at arm's length price since it is done at a Cost-Plus mark-up which is higher than the mark-ups in similar transactions, a deeper analysis shows otherwise. It is in this background that the Transfer Pricing laws and Section 92 of the Income Tax Act become important.

3. METHODS TO CALCULATE THE ARM'S LENGTH PRICE: SECTION 92C

Before the author can move on to explain and analyse the possible arguments that can be put forward by the respective parties, it is essential to briefly explain the various methods for calculating the arm's length price in an international transaction.[4]The various methods for computing the arm's length price are mentioned in Section 92C of the Income Tax Act, 1961. As per the Section, the five methods[5] are:

(1) Comparable Uncontrolled Price Method
(2) Resale Price Method
(3) Cost-Plus Method
(4) Profit Split Method
(5) Transactional Net MarginMethod

Further, there is no hierarchy among these methods. The Most Appropriate Method for any transaction has to be determined keeping

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[3] As per Section 92CC of the Income Tax Act, 1961, an Advanced Pricing Agreement is an agreement signed between the assessee and the revenue for determining the arm's length price or specifying the manner in which it is to be determined. Further, once the agreement has been entered into, it alone governs the calculation of the arm's length price notwithstanding anything contained in Section 92C. The agreement is binding on both the assessee and the revenue and it has all the requisites of a legally binding contract.

[4] The term 'International Transaction' is defined by Section 92 of the Income Tax Act. As per the section, 'international transaction' means any transaction which happens between two or more associated enterprises, one of whom should be a non-resident. This transaction can range from the purchase, sale or lease of both intangibles and intangibles to the provision of services, lending of money or any other transaction having any kind of bearing on the profits of the enterprise.

[5] The *Income Tax Act*,1961, section 92C; the Central Board of Direct Taxes may also specify any other method if it so deems fit.

in mind the various factors enumerated in Rule 10C of the Income Tax Rules.[6]

3.1. Comparable Uncontrolled Price Method

This method is the most direct method for computing the arm's length price. Under this method, the price at which a transaction between associated enterprises is purported to be carried out is compared to the price obtained in a similar/comparable uncontrolled transaction. Comparable Uncontrolled transaction means any transaction which is in all material aspects similar to the international transaction in question. This method is the easiest and is the most appropriate method when details regarding similar transaction, whether internal or external, are available.[7]

3.2. Resale Price Method

Resale Price Method is the most appropriate method when the seller, who is an associated enterprise, adds little value to the goods and does not alter the goods physically before selling it again to a third party. In other words, this method is the best method in case of distribution activities and services. The first step under this method is to identify the price at which the goods or services were sold to the unrelated party. The second step involves deducting the gross profit from the resale of such property and any expenses incurred by the firm while reselling. The adjusted price arrived at will be the arm's length price.[8]

3.3. Cost-Plus Method

Comparable Uncontrolled Price Method and Resale Price Method can be difficult to apply in cases where no comparable transactions are available. This problem is, to some extent, solved by the other three methods mentioned in Section 92C including the Cost-Plus Method. The Cost-Plus Method begins by taking into account the costs incurred by the supplier of goods or services in a controlled (related party

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[6] As per Rule 10C, the Most Appropriate Method (MAM) has to be determined keeping in mind the nature and class of international transaction, assets employed and risks assumed by each associated enterprise, availability of comparable uncontrolled transactions and the nature and reliability of assumptions required for the application of the method.

[7] Deloitte, *Transfer Pricing Law and Practice in India*, 181 (2nd ed., 2009).

[8] *Income Tax Rules,* 1962, rule 10B.

transaction), to which an appropriate mark-up is added, to account for an appropriate profit considering a number of factors including the risks assumed, functions performed and assets employed.[9] The price thus reached is the arm's length price for the transaction in question. In cases where comparable transactions of the tested party with an independent party are not available, resort can be made to comparable dealings of independent parties in uncontrolled parties. This method is the most appropriate method when the transaction in question involves provision of services, a long-term buy and supply agreement, sale of semi-furnished goods or specialised goods like military equipment.[10]

3.4. Profit-Split Method

Under the Profit-Split Method, the arm's length price for an international transaction between associated enterprises is determined by taking into account the consolidated netprofits of the company as a whole and dividing the same on an economically valid basis. The profits have to be divided keeping into account a host of factors such as contributions made by each firm, risks assumed, assets employed etc.[11] Profit-Split Method can be used even when no comparable transaction is available. However, since an important step while applying this method is analysing the contributions made by each associated enterprise, it might pose difficulties for tax authorities to process information from foreign affiliates.[12]

3.5. Transactional Net Margin Method

Under the Transactional Net Margin Method, the net profit of the firm from an international transaction is determined and compared with the net profit margins of comparable firms in uncontrolled transactions after adjusting and accounting for differences which may materially affect the net profit margins in open market. The net profit margin realised after comparing with uncontrolled transactions after taking into account and adjusting for all the difference is then used to arrive at the arm's length price.[13]

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[9] *supra* 7, at p. 199.
[10] V.S Vahi, *Transfer Pricing: Law, Procedure and Documentation,* 102 (2004).
[11] *Income Tax Rules*, 1962, Rule 10B (d).
[12] *supra*10, atp.116.
[13] *supra*10, atp.122.

4. ARGUMENTS THAT CAN BE ADDUCED ON BEHALF OF REVENUE

In such cases, the revenue is most likely to agree with the assessee on the applicability of the Cost-Plus Method since the mark-up on cost selected by the assessee for the computation of arm's length price is higher than it is in similar transactions. However, once the revenue gets wind of the further transactions that happen between the various subsidiaries, it would try to re-assess the income of the assessee. Some of the arguments that can be put forward by the revenue are as follows:

4.1. Profit- Split Method was the Most Appropriate Method

The first argument that the Revenue could take to protect the company from shifting its income to low tax jurisdictions is the applicability of the Profit-Split Method. The Revenue can contend that the Profit-Split Method is the most appropriate method for a number of reasons as follows:

4.1.1. Comparables are not available

As mentioned above, under the Cost-Plus Method, arm's length price for an international transaction is determined by adding a normal gross profit mark-up to the sum of both direct and in-direct costs incurred by the enterprise to develop the property or for the provision of services. After the mark-up is determined, it is adjusted to take into account functional, risk and other differences between the international transaction and uncontrolled transaction which are comparable to the transaction in question. The costs are then increased by such mark-up and the sum arrived is the arm's length price.[14]The OECD guidelines on Transfer Pricing also lay down the same rules for the application of CPM.[15]Thus, one essential condition for the application of CPM is finding uncontrolled transactions, which are comparable to theinternational transaction in question.Thus, it was observed in *Assistant Commissioner of Income Tax, Circle 2, Nashik* v. *MSS India (P) Ltd.*[16], that:

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[14]*Income Tax Rules*, 1961, Rule 10B(c).

[15] OECD (2010), *OECD Transfer pricing guidelines for Multinational Enterprises and Tax Administrations*, ¶2.39, (22/07/2010), available at http://www.oecd.org/ctp/transfer-pricing/45765701.pdf (last accessed on 28 August 2015).

[16]Assistant Commissioner of Income Tax, Circle 2,Nashik v. MSS India (P) Ltd, [2009] 32 SOT 132 (Pune); See also, Assistant Commissioner of Income Tax, Mumbai v.

> When we are applying a traditional or standard method of ALP determination, all that is to be seen is whether or not the mark up over costs relating to such sales to Associated Enterprises (AE) or the prices of such sales to AEs are comparable with mark up over costs relating to such sales to non AEs or prices at which same product is sold to non AEs…

Since, the transaction involved the licensing of unique intangibles, no comparable was available and hence, Cost-Plus Method cannot be applied. On the other hand, finding comparables is not *the sine qua non* for applying the Profit-Split Method.In the absence of external data as to how independent, enterprises would have split the profits in an uncontrolled transaction; the best judgement analysis taking into consideration the functions performed, risks assumed etc. can be used to split the profit.[17]The Income Tax Rules stipulate the same.[18]Thus, in *Altman Delta Corporation* v. *Commissioner of Internal Revenue*[19]*,* Profit-Split Method was chosen over the Cost-Plus Method since the comparability analysis done by the revenue was flawed and no other comparables were available.Similarly, in *Eli Lilly v. Commissioner*[20], the profit was split between an American company and its subsidiary in Puerto Rico using the best judgment method in a ratio of 45:55. Thus, Profit-Split Method and not Cost-Plus Method should have been applied.

4.1.2. The transaction involved the transfer of intangibles

Profit-Split Method is usually the most appropriate method in transactions, which involve the transfer of unique intangibles.[21] The OECD guidelines on transfer pricing also regard Profit-Split Method as the most appropriate method to determine the arm's length price for the sale or licensing of unique intangibles.[22] Since, the transaction in question involved transfer and licensing of unique intangibles, Profit Split Method was the most appropriate method.

Tara Ultimo Pvt.. Ltd. ; Income Tax Officer, Baroda v. Kawin Interactive (P.) Ltd., IT Appeal Nos. 4474, 4475 (Ahd.) (2007).

[17]*supra* 15, at2.111.

[18]*Income Tax Rules*, 1962, Rule 10B(d)(ii).

[19] Altman Delta Corporation v. Commissioner of Internal Revenue, 246 F.3d 49, 70 (2d Cir.,2001).

[20] Eli Lilly v. Commissioner, 84 T.C. 996 (1985).

[21]Income Tax Rules,1962, Rule 10B.

[22]*supra* 15, at 2.109.

4.1.3. The Company (Elixir India in this case) was an entrepreneurial research and development centre

Circular number 6/2013, which was issued by the CBDT on June 29th, 2013, classified development centres into three categories: Entrepreneurial research and development centres, Centres which are based on cost sharing arrangements, and Contract research and development centres.[23] As per the guidelines given in the Circular, a centre will be called a contract and development centre with insignificant risks only when the parent company performs all the economically significant functions, the parent company provides the intangibles funds and assets for the development of the product including intangibles or the Indian company works under the supervision of the foreign company.[24] Further, the Circular also makes it explicitly clear that an Indian company will be assumed to bear all the risks if the parent company or foreign affiliate is located in a low tax jurisdiction. In the instant case, all the economically significant functions were performed by the Indian Company (Elixir India) and it did not work under the supervision or control of any of the foreign companies (Elixir Ireland or Elixir Netherland). Furthermore, Elixir Ireland 1 was controlled and managed from Malta, which is a low tax jurisdiction since it does not impose any tax on royalties received from the licensing of intangibles. Thus, the Indian company was an entrepreneurial research and development centre and not merely a contract research and development centre. It is a settled business-principle that the profits in business depend on risks i.e. higher the risks, higher will be the rate of profit. In the instant case, since the Indian company bore all significant risk, remunerating it only for the transfer of intangibles at a mark-up above the costs was not justified.Central Board of Direct Taxes, *Circular No. 19/2015*, dated 27 November 2015

4.1.4. The Revenue does not need to furnish any material

The assessee can contend that the revenue cannot re-assess its income that too without providing any information or material about the inadequacy of the method already employed. In response to such an argument, the revenue may argue that it does not need to furnish any

[23] Central board of Direct Taxes,*Circular 6/2013*, dated 29 June 2013, available at http://law.incometaxindia.gov.in/DIT/File_opener.aspx?page=CIR&schT=&csId=0fb5c6c3-a839-4fb5-ab5e-9f46f89c97c0&crn=&yr=ALL&sch=&title=Taxmann%20-%20Direct%20Tax%20Laws (last accessed on 28 August 2015).

[24] *ibid.*

material in order to impugn the method already employed for the computation of the arm's length price. For doing the same, the revue may rely on several rulings.In *Serdia Pharmaceuticals* v. *Assistant Commissioner of Income Tax, Mumbai*[25], it was observed that if the assessing officer is of the opinion that the method adopted by the appellant is not the most appropriate method in light of the facts and circumstances of a case, he has powers and a corresponding duty to reject the method adopted and he need not show that the arm's length was not calculated according to the provisions of section 92 of the Income Tax Act, 1961.[26]

4.2. The Revenue has the jurisdiction to tax the offshore transactions of the company

One of the main contentions from the assessee can be the want of jurisdiction of the Revenue to tax the offshore transactions of the company i.e. transactions which, in this case, happened between Elixir Ireland 1 and its subsidiaries. The revenue can in turn take two counter-arguments in response to this as follows:

4.2.1. Offshore transactions can be taxed by using the Profit-Split Method

Since, the revenue has already argued for the applicability of the Profit-Split Method, it can take into account the net profits of the company as a whole, including the profits made by its subsidiaries and split them after analysing the functions performed and risks assumed by each entity.The company can contend that since the Indian Company was just a Permanent Establishment of the Irish Holding Company, therefore the Income Tax Department (hereinafter referred to as **'ITD'**) has no jurisdiction to tax the income that is not reasonably attributable to the operations carried out in India. To rebut the same, the revenue can rely on a number of cases including Morgan Stanley,[27] which was pronounced by the honourable Supreme Court in 2007. In this case, it was observed by the apex court if the Indian Company bears substantial risks, the ITD can tax the income of the company for the risks that it is bearing. Since, the Indian company (Elixir India) bore risks for the

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[25] Serdia Pharmaceuticals v. Assistant Commissioner of Income Tax, Mumbai, ITA Nos: 2469/Mum/06, 3032/Mum/07 and 2531/Mum/08, Assessment year: 2002-03, 2003-04 and 2004-05.

[26] *ibid.* See Also, Assistant Commissioner Income Tax, Mumbai v. Sonata Software Ltd, ¶16, [2013] 29 taxmann.com 144 (Mumbai - Trib.).

[27] Director of Income Tax (International Taxation) v. Morgan Stanley and Co., [2007] 162 TAXMAN 165 (SC).

development of the intangibles which was very crucial for any further offshore transactions; the ITD has the jurisdiction to tax the income accruing from the same by applying Section 9(1) of the Income Tax Act, 1961, which empowers the ITD to tax a non-resident for the profits that can be reasonably said to have accrued due to operations carried out in India.[28]

4.2.2. The 'Look at Principle'

Associated enterprises very often structure their transactions in a way which minimises their tax liability.[29] To prevent the same, the revenue can resort to 'Look at Principle'. The principle was explained by the Supreme Court in *Vodafone International Holdings Ltd.* v. *Union of India*[30]. The court held that the tax authorities must ascertain the legal nature of certain transactions by following the 'look at principle' where the transaction must be looked at as a whole without dissecting it to see if the transaction is meant for tax avoidance or not. The Transfer Pricing Officer's task is therefore to often look behind the facts as they seem and arrive at the substance of the transaction to compute the value of the transaction. Thu, the revenue has jurisdiction to tax the income of the company as a whole by invoking the 'look at principle'.

5. ARGUMENTS FROM THE COMPANY

To rebut the arguments adduced by the revenue, the company can also take a number of arguments. Some of the major arguments that can be put forward by the company are as follows:

5.1. The Cost-Plus Method is the most appropriate method

Contrary to the stance taken by the revenue, the company would argue for the applicability of the Cost-Plus Method on the following basis:

5.1.1. The transactional profit methods are methods of last resort

According to the OECD guidelines on Transfer Pricing, even though the application of the MAM depends on the facts and circumstances of

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[28] The *Income Tax Act*, 1962, Section 9(1), Explanation 'a'.

[29] *supra* 18. See also, Li and Fung India (P) Ltd. v. Commissioner of Income Tax, [2013] 40 taxmann.com 300 (Delhi).

[30] Vodafone International Holdings Ltd. v. Union of India, Civil Appeal No.733 of 2012, (arising out of S.L.P. (C) No. 26529 of 2010).

each case, the traditional methods including the CPM is preferable over transactional net profit methods including the Profit-Split Method.[31] Though Section 92C (1) of the Income Tax Act, 1961 does not give preference to any method over others, judgements given by various tribunals up-held that the Transactional Profit Methods are methods of last resort. Thus, in *Assistant Commissioner Income Tax, Mumbai* v. *Sonata Software Ltd.*[32]*,* it was observed that the transactional profit methods are to be considered methods of last resort and ordinarily only traditional methods should be applied. Similar observations were made in *Philips Software Centre Pvt Ltd* v. *Assistant Commissioner of Income Tax*[33].

5.1.2. There is an agreement for the provision of services

According to the OECD guidelines on Transfer Pricing, Cost-Plus Method is the most appropriate method in cases where there is an agreement for the provisions of services. The guidelines define intra-group services as any activity that provides any group member or the whole group with economic or commercial value to enhance its commercial position.[34]Thus, in *Li and Fung India (P) Ltd.* v. *Commissioner of Income Tax*[35], Cost-Plus Method was considered as the most appropriate method since there was a provision of services by LFIT (subsidiary) to its parent company. Similarly, it was observed in *Aztec Software and Technology Services Ltd.* v. *Assistant Commissioner of Income Tax*[36]*,* that the Cost-Plus Methodis usually used in cases which involve the provision of services. Since, the Indian Company was providing research and development services to the Irish company, Cost-Plus Method would be most appropriate.

5.1.3. The Indian Company (Elixir India) was a mere contract research and development centre

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[31]OECD (2010), *OECD Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations*, ¶2.3, 60 (22/07/2010).

[32]Assistant Commissioner Income Tax, Mumbai v. Sonata Software Ltd, ¶16, [2013] 29 taxmann.com 144 (Mumbai - Trib.).

[33]Philips Software Centre Pvt Ltd v. Assistant Commissioner of Income Tax, [2008] 26 SOT 226 (Bang.). See also, Assistant Commissioner of Income Tax, Circle 2, Nashik v. MSS India (P) Ltd, [2009] 32 SOT 132 (Pune).

[34]OECD(2010), *OECD Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations*, ¶7.6, (22/07/2010).

[35]Li and Fung India (P) Ltd. v. Commissioner of Income Tax, [2013] 40 taxmann.com 300 (Delhi).

[36]Aztec Software and Technology Services Ltd. v. Assistant Commissioner of Income Tax, 2007 107 ITD 141.

The risk borne by a contract R&D centre is lower compared to fully entrepreneurial enterprises. Where a company provides captive contract software development service, it is immune from all risks that arise from market fluctuations, on account of it being assured of appropriate mark-up on costs.[37] Similarly, in *Li Fung*[38] where the subsidiary assumed risks and put in its resources for the development of tangibles as well as unique intangibles for its parent company, it was still observed that the company was just a service provider and not an entrepreneurial entity since it was immune from all kinds of risks that arise from market fluctuations. In the instant case, since the Elixir India was immune from all kind of risks including, market, credit and product development risks, it was a mere Contract research and development centre and hence, a mark-up on costs was justified.

5.1.4. Applicability of safe-harbour rules

The government vide its press release issued on 14/8/2013 notified the safe harbour rules.[39] According to Rule 10TD of the said rules, a company providing development services wholly or partly relating to generic pharmaceutical drugs will be protected if the operating profit margin of the assessee for the international transaction in relation to its expenses is more than 29 per cent.[40] The company can contend that since the operating profit for the transaction in question was more than 29 per cent, the safe harbour rules will be applicable and no adjustments are required.

5.2. Revenue does not have jurisdiction to tax the offshore transactions of the company

Another important argument that can be put forward by the company is the want of jurisdiction of the Indian Income Tax Department to tax the offshore transactions of the company. The major arguments can be:

5.2.1. Tax can be imposed only on the income received by the Indian company for the R&D work

[37]Philips Software Centre Pvt Ltd v. Assistant Commissioner of Income Tax, [2008] 26 SOT 226 (Bang.).

[38]*supra* 35.

[39]Central Board of Direct Taxes, *Press Release*, Transfer Pricing Safe harbour Rules, available at, http://www.itatonline.org/info/index.php/transfer-pricing-final-safe-harbour-rules-available-for-download/ (last accessed on 28 August 2015).

[40]*ibid*; For the applicability of these rules to other industries, see Rule 10TD(2).

The Irish company is earning profits from the sale of the drug by its subsidiary. The subsidiary company is responsible for the exploitation of the IPRs, the formulation of the drug and its sale subsequently. None of these operations are carried out in India. Hence, the profits accruing out of the sale of the drug cannot be reasonably attributable to the Indian company's operations carried out in India. Since both the Irish company and its subsidiary are non-residents of India as per Section 6 of the Income Tax Act, 1961, [41] the income accrued in India by these companies would be governed under Section 9 of the Act. Section 9(1)(i), Explanation 1 states that when all the operations of a business are not carried out in India, only that part of the income which is reasonably attributable to the operations carried out in India would be deemed to have accrued in India.[42] In *Li Fung*,[43]it was held that even if the Indian Company provided assets and assumed risks for the development of unique intangibles, the tax authorities were misdirected in deciding that LFIL assumed substantial risks. Since, LFIL did not have any expertise in the manufacture of garment nor did it bear any risks for the manufacture and export of garments, it cannot be held to be a part of transaction with the third party vendors. Applying the ration to the instance case, the revenue does not have jurisdiction to tax the offshore transactions of the company.

5.2.2. The Indian company was a mere Permanent Establishment of the Irish Company for tax purposes

Section 92F of the Income Tax Act, 1961 defines a permanent establishment (hereinafter referred to as **'PE'**) as *a* permanent place from where the business of an MNE is wholly or partially carried out.[44] The definition given under Section 92F is an inclusive definition and includes service PE, agency PE etc.[45] Since, employees and technical experts from the Irish subsidiary frequented the office of the Indian company, the Indian company (Elixir India) was a mere PE of the Irish

[41]The *Income Tax Act*, 1961, section 6.

[42]The *Income Tax Act*, 1961, section 9(1)(i). See also, Dy. CIT v. Roxon Oy., [2007] 291 ITR 275 (AT).

[43]*supra* 35; the Court clearly ruled that to attribute the profits of manufacture and export to LFIL would lead to a "completely unwarranted inference" that LFIL was a partner of the manufacturer vendor even when all the costs and substantial risks involved for the manufacturing and export were borne by third parties and not LFIL.

[44]The *Income Tax Act*, 1961, section 92F(iii).

[45]Director of Income Tax (International Taxation) v. Morgan Stanley and Co., [2007] 162 TAXMAN 165 (SC).

company so far as the transaction in question is concerned.[46] Since, a foreign enterprise is only liable to be taxed in India on so much of its business profits as is attributable to the PE,[47] and the Indian company is a PE of the Irish Company, the ITD has no jurisdiction to tax anything except that part of the business profits earned by Irish Company which can be attributed to operations carried out by the Indian company in India.

6. CONCLUSIONS AND SUGGESTIONS

Associated enterprises very often structure their transactions in a manner most conducive to helping them avoid taxes.It is for this very reason that Transfer Pricing has become one of the most important subjects in International Taxation. In recent years, multi-national giants like Google and Facebook has resorted to a new arrangement for shifting their incomes to low tax havens like Bermuda and Malta. This arrangement popularly called as *the Double Irish Dutch Sandwich* can help such multi-nationals to drastically reduce their tax liability and save hefty amounts of their operating profits. With the help of this paper, the author explained the structure of the Double Irish Dutch Sandwich by using a hypothetical and the arguments that can be adduced by the revenue as well as the assessee. From the arguments explained in detail above, it is evident how the structure can tangle up the Indian Income Tax Department in unending litigation and transfer pricing adjustments, thereby causing huge loss to it. Even though the law related to Transfer Pricing has taken cue from the OECD guidelines and evolved a long way to prevent associated enterprises from evading taxes, it still needs a few changes and amendments to deal adequately with the Double Irish Dutch Sandwich. Some of the changes that the author proposes are as follows.

6.1. Applicability of the Profit-Split Method in case of intangibles

[46] Convergys Customer Management Group Inc. v. Assistant Director of Income-tax (International Taxation), Circle-1(1), New Delhi [2013] 34 taxmann.com 24 (Delhi – Trib).

[47] Director of Income Tax (International Taxation) v. Morgan Stanley and Co., [2007] 162 TAXMAN 165 (SC), CIT v. Hyundai Heavy Industries Co. Ltd., (2007) 291 ITR 482 (SC), Convergys Customer Management Group Inc. v. Assistant Director of Income-tax (International Taxation), Circle-1(1), New Delhi [2013] 34 taxmann.com 24 (Delhi – Trib).

The success of any modern day corporation is to a large extent contingent on technological innovations. It is because of this reason that Intellectual Property assets are far more valuable than tangible assets these days. Both the OECD guidelines and the Indian Income Tax Rules, 1962 say that Profit-Split Method is usually the most preferred method in case of intangibles. However, the government vide its circular 5/2013 withdrew an earlier circular which made Profit-Split the most preferred method in case of intangibles. The reason given was the apparent hierarchy that the circular seemed to create. Since, the Double Irish Dutch Irish Sandwich is particularly effective in case of intangibles;the problems posed by it can be solved if Profit-Split Method is compulsorily made the most-appropriate method in case of intangibles.Cost-Plus Method is the most-appropriate method in case of specialised goods or long-term buy and supply agreements and the Resale Price Method is the one used in case of distribution activities. Hence, there already exists some kind of hierarchy among the various methods available to calculate the arm's length price. Thus, withdrawing the circular just because it seemed to create some sort of hierarchy among the various methods is off the mark.

6.2. Clarifications regarding Research and Development Centres

Another flaw in the existing legal framework on Transfer Pricing is the lack of clarity to identify research and development centres. As mentioned above, the company using the Double Irish Dutch Sandwich can very easily avoid tax by contending that it is a contract research and development centre with limited risk. The guidelines mentioned in Circular 6, dated 20/6/2013, to identity R&D centres are not cumulative.[48] That means that the Indian R&D centre may own the intangibles but may still be classified as a mere contract R&D centre. Making the guidelines cumulative will be a bit restrictive for the companies but preventing tax avoidance should be given preference even if leads to hardships for a few companies.

6.3. Cancellation or breach of Advanced Pricing Agreements

[48]Income Tax Department, *Circular No.*06/2013 [F NO. 500/139/2012], available at http://www.incometaxindia.gov.in/_layouts/15/dit/pages/viewer.aspx?path=http://www.incometaxindia.gov.in/communications/circular/910110000000000665.htm&k=&opt=&isdlg=0 (last accessed on 28 August 201 3).

Matter would have been ten times worse had the revenue signed an Advanced Pricing Agreement with the assessee. As mentioned above, an Advance Pricing Agreement is binding on both the parties and the revenue can unilaterally cancel it only if there is fraud or misrepresentation on part of the assessee. However, the provisions related to Advanced Pricing Agreement do not clarify the appropriate remedy available to either of the parties in such a case. Assuming that an Advanced Pricing Agreement is unilaterally cancelled by the revenue, would an appeal lie with the Income Tax Appellate tribunal or would ordinary courts have jurisdiction? Further, can either of the parties to the agreement ask for specific performance or damages in case of breach? These are some of the questions left unanswered by the current legal framework. The author thinks that these matters need to be clarified in order to make the APA scheme more viable and beneficial for both the parties.