TRANSFER

PRICING

INSIDE

INTRODUCTION

With an increasing participation of multi-national companies in economic activities, which has given rise to introduction of new laws, rules and regulations by the Government in the day to day business activities.

The Transfer Pricing Law is one among them which emerges out from such participation by the companies.

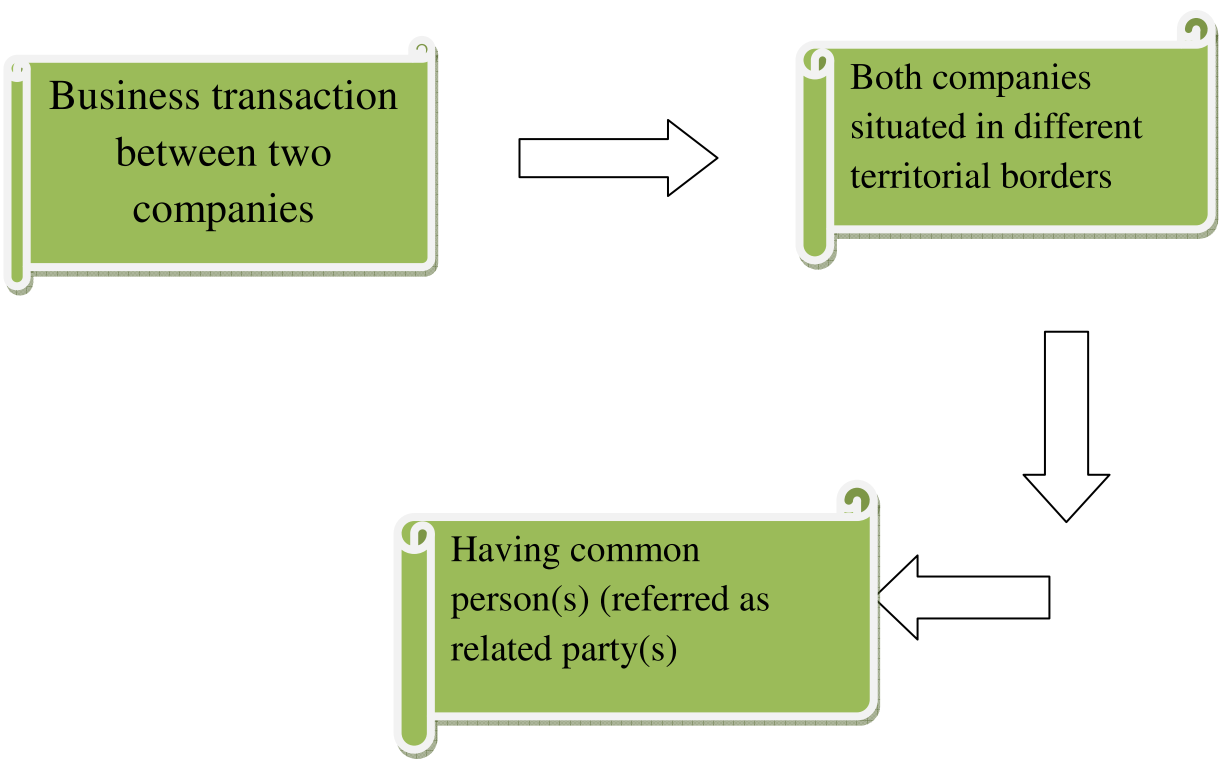
The new Sections 92A to 92F inserted under Sec.92 introduced in the Finance Act, 2001 explains about the definition of Associated Enterprise and International Transactions,computation of Transfer Price under the principle of Arm's Length Price, documents to be maintained, Role of a CA in Transfer Pricing.

WHAT IS TRANSFER PRICING?

Transfer Pricing is the general term used for pricing of cross border, intra-firm transactions between related parties.

It therefore refers to the setting of prices at which transactions are settled, which involves a transfer of property or service between associated enterprises.

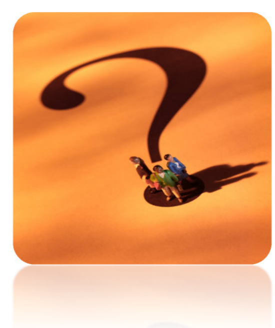
WHEN IS TRANSFER PRICING RULES APPLICABLE?



NEED FOR INTRODUCTION:

Since liberalization, Companies from developed countries started setting up 100% subsidiaries in India for backdoor profits. Indian Government was losing revenue in form of Tax so Finance Act, 2001 has introduced provisions for Transfer Pricing with effect from Assessment Year 2002-03.

WHAT IS ARM'S LENGTH PRICE (ALP)? (SEC92)



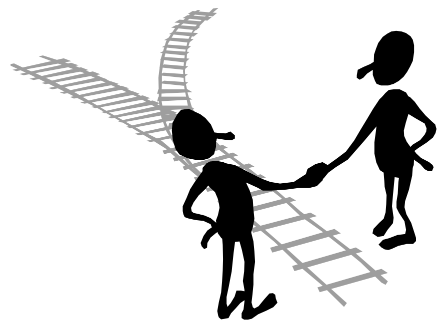
When an intercompany transaction takes place, the transfer price charged should be computed in a manner :

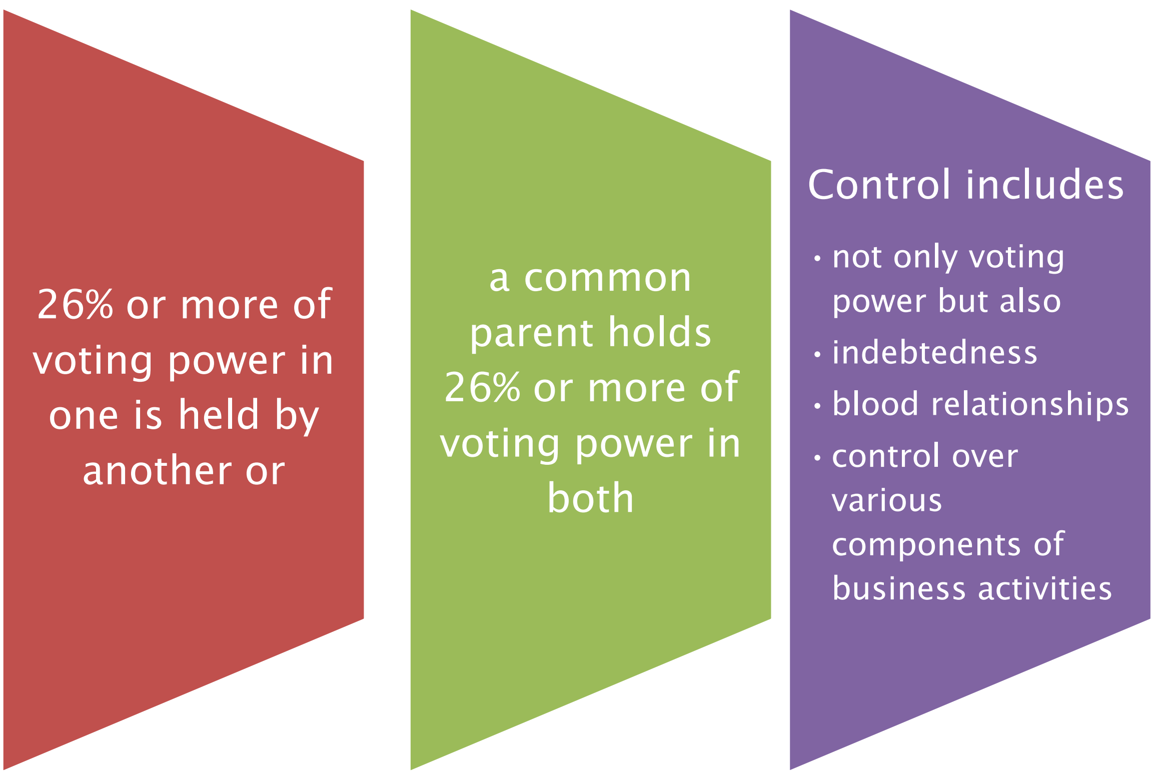
- What a seller should charge an independent, unrelated customer
- or what a buyer would pay an independent, unrelated Seller

When an international transaction takes place between the associated enterprise, the price that would be chargeable to such transaction will be computed if the same is entered between the unrelated parties.

MEANING OFASSOCIATED ENTERPRISE:

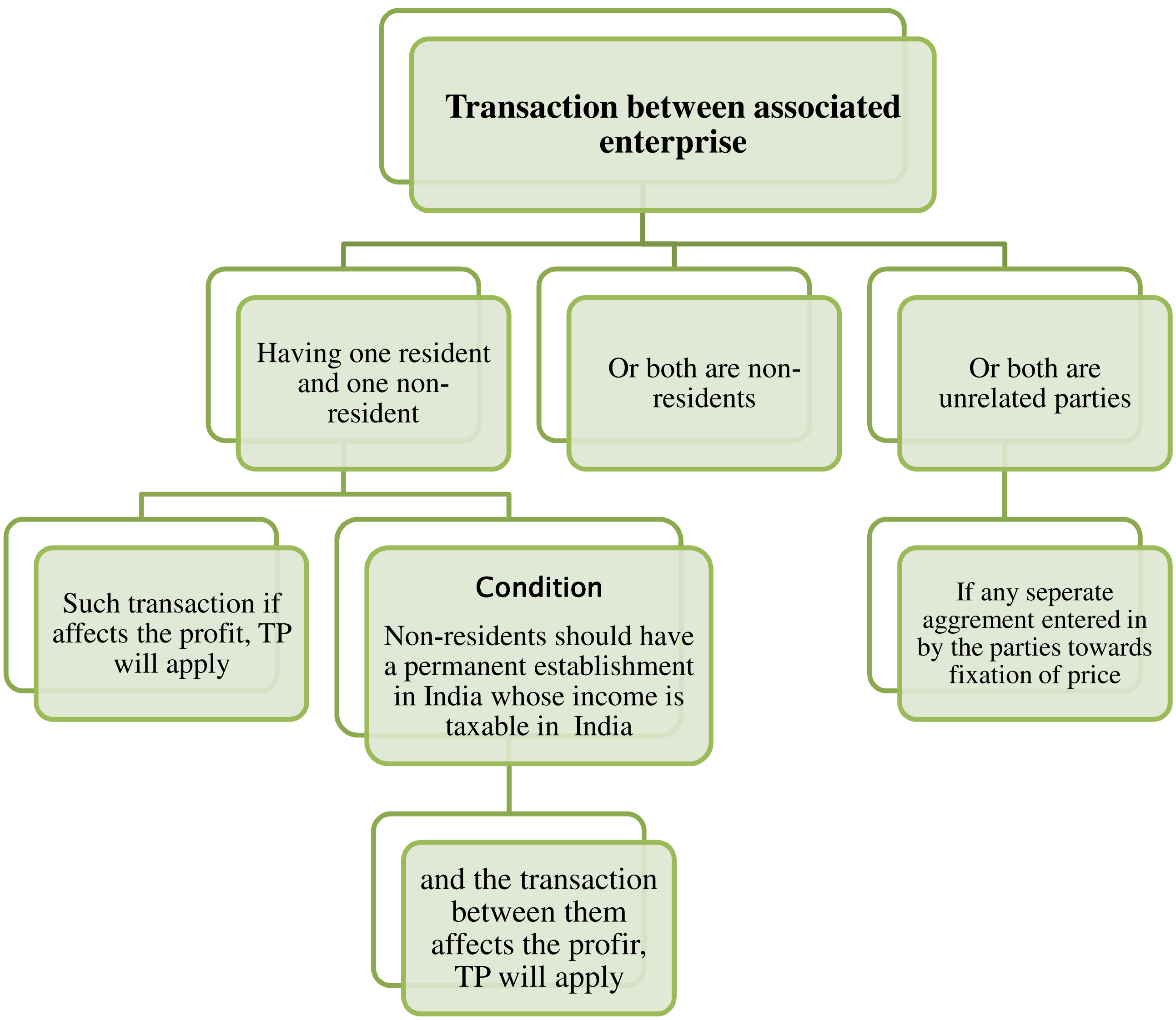
(SEC 92A)





Transfer pricing provisions are applicable when there is a transaction having a bearing on the profits, income, losses or assets of such enterprises.

<u>MEANING OF INTERNATIONAL TRANSACTION:</u> (SEC 92B)



COMPUTATION OF ARM'S LENGTH PRICE (SEC 92C)

- Comparable Uncontrolled Price Method
- Cost Plus Method
- Resale Price Method
- Profit Split Method
- Transactional Net Margin Method

The most appropriate method shall be applied, for determination of arm's length price, in the manner as may be prescribed

Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.

➢ <u>**Computation of ALP under Comparable Uncontrolled Price Method**</u>

STEP 1 — Determine the price charged or paid for the property transferred or services provided in a comparable uncontrolled transaction.

STEP 2 — Such price is then adjusted to account for the Functional Differences between the International Transaction and Comparable Uncontrolled Transaction *, which could materially affect the price in the open market.

STEP 3 — Such adjusted price is the Arm's Length Price.

*A method used by the IRS to determine if prices reported for an intangible property are comparable to prices for similar property in arm's length transactions. Intangible property includes such things as patents, processes, designs, copyrights, and trademarks.

➢ Computation of ALP under Cost Plus Method

STEP 1

Determine the direct and indirect costs of production in respect of property transferred or services provided to an associated enterprise.

STEP 2

Determine the normal Gross Profit mark up to such costs which will arise from transfer of similar goods and services to an unrelated enterprise or in a comparable uncontrolled transaction.

STEP 3

The normal Gross Profit mark up should be adjusted to account for the functional differences if any between the International Transaction and Comparable Uncontrolled Transaction which could materially affect such profit mark-up in the open market .

STEP 4

The cost arrived at Step 1 shall be increased by the adjusted profit mark up arrived.

STEP 5

The sum so arrived is the ALP.

- **Computation of ALP under Resale Price Method**

STEP 1

The price at which the property purchased or the services obtained by the enterprise are sold to an unrelated enterprise is first determined.

STEP 2

Such Resale Price is reduced by the Normal Gross Profit Margin accruing to the enterprise from the purchase and resale of Similar Goods in a Comparable Uncontrolled Transaction. If there is no Comparable Uncontrolled Transaction then take Gross Profit of an unrelated person from purchase and resale of Similar Goods.

STEP 3

Then reduce the expenses incurred by the enterprise in connection with purchase of property.

STEP 4

The price so arrived is adjusted to account for the functional differences in the International Transactions and the Comparable Uncontrolled Transaction which could materially affect the Gross Profit Margin in the Open Market.

STEP 5

The adjusted price is the ALP.

- **Computation of ALP under Profit Split Method**

This Method is applied in multiple International Transactions which are inter-related that they cannot be evaluated separately.

STEP 1

Compute the net Profit of the Associated Enterprise arising from International Transaction.

STEP 2

Compute the relative contribution made by each of the associated enterprise to the earning of the combined net profit.

STEP 3

Split the combined net profit in proportion to their contribution.

STEP 4

The sum so arrived is the ALP.

- **Computation of ALP under Transactional Net Margin Method.**

STEP 1

Compute the Net Margin realized by the enterprise from an International Transaction entered into with an associated enterprise.

STEP 2

Compute the Net Profit Margin realized by the enterprise or by an unrelated enterprise from a Comparable Uncontrolled Transaction.

STEP 3

Adjust the Net Profit Margin computed in Step 2 to account for the differences.

STEP 4

The Net Profit Margin computed in Step 1 is established to be the same as the Net Profit Margin referred to in Step 3.

STEP 5

The Net Profit Margin thus established is taken into account to arrive at an ALP in relation to the International Transaction.

It has also been provided that no deduction u/s 10A or 10 AA or 10 B or under Chapter VI-A shall be allowed in respect of the income by which the Total Income of the Assessee is enhanced after computation of income.

Most Appropriate Methods

- ✓ Cost plus method (CPM): this method is generally used where semi finished products are transferred.

- ✓ Comparable Uncontrolled Prices Method (CUP): this not favorable as no public database is accessible concerning prices apply by autonomous enterprises in import of comparable products.

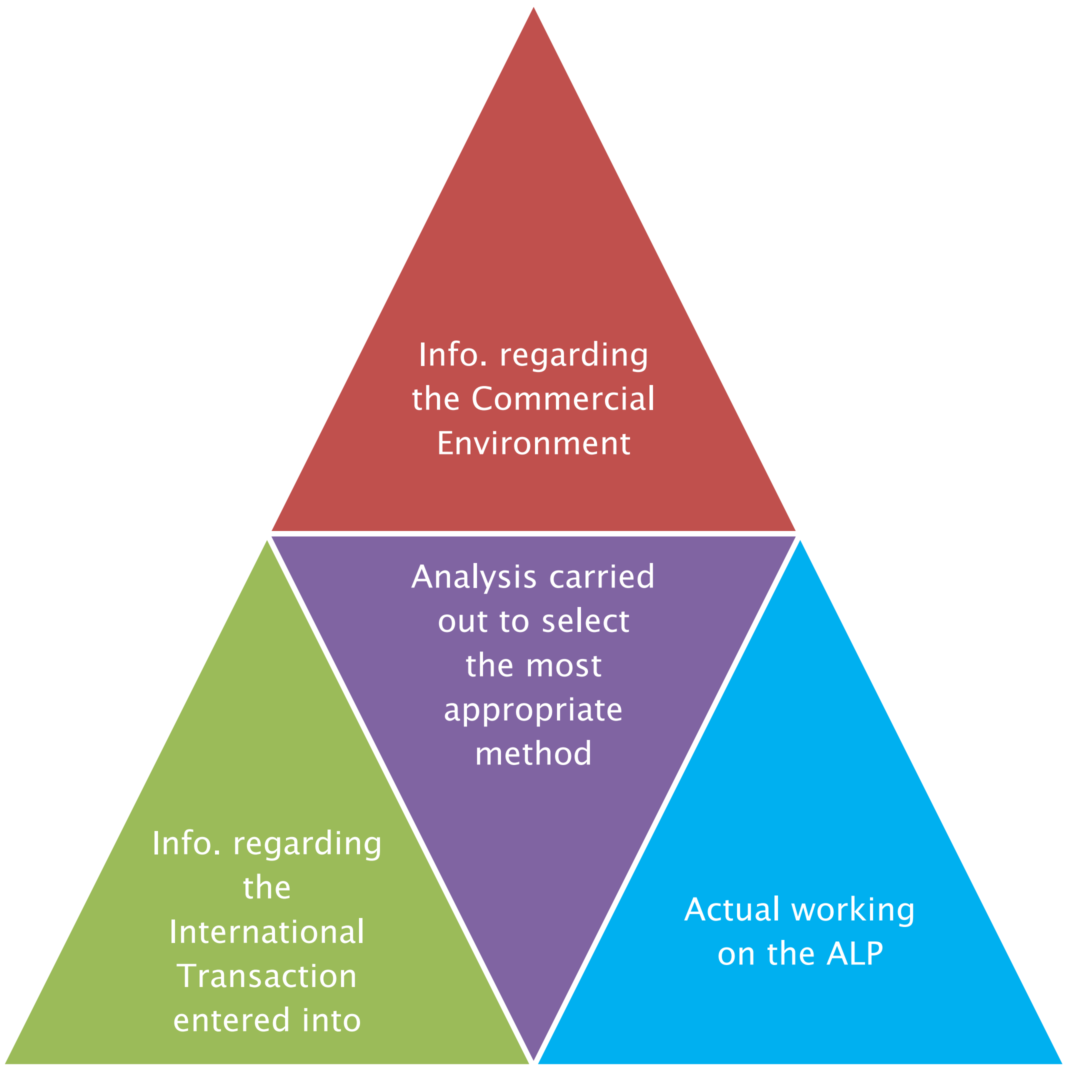
- ✓ Resale Price Method (RPM): In this method the vendor adds comparatively small or no value to goods taken from associate enterprises. In the current case in this method may be taken as the very important method as similar data of comparable deals by independent entities is available.

- ✓ Profit Split Method (PSM): PSM method is used when associate enterprises are so combined that it turns into difficult to make transfer pricing analysis on transactional methods basis.

- ✓ Transactional Net Margin Method (TNMM): In this method generally apply in the case of transfer of partially completed products, distribution of completed goods and where RPM cannot be sufficiently applied. In general RPM more suitably applied in this case, TNMM is also not right.

DOCUMENTATION: (SEC92D)

The most important details to beDocumented by the assesseincludes the following:



All these details are to be maintained by the taxpayer **for a period of 8 years** for future proceedings on these, if any.

ROLE OF CHARTERED ACCOUNTANTS (SEC 92E)

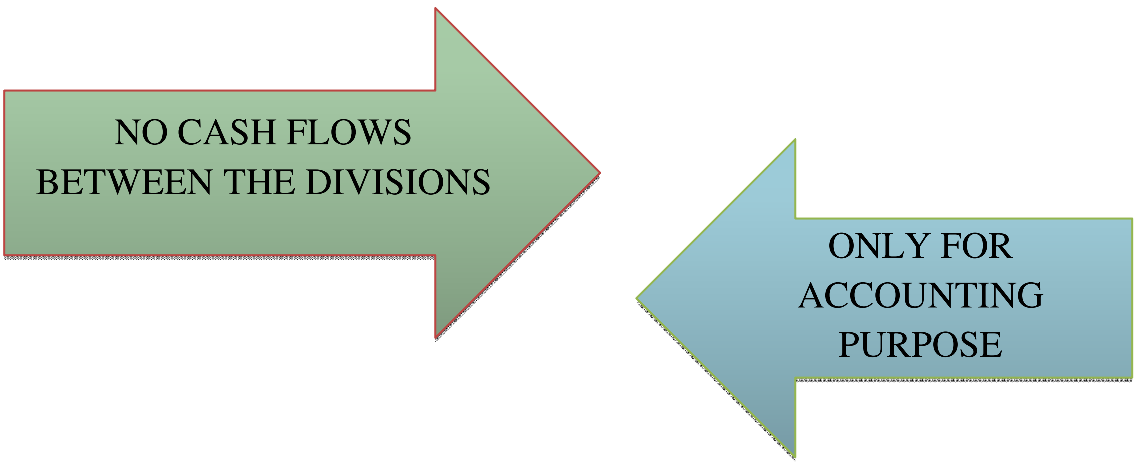
The taxpayer should obtain **FORM 3CEB**from the auditor where the auditor should certify the international transaction entered in, the calculation of Arm's Length Price, the documentation maintained by the taxpayer, etc.

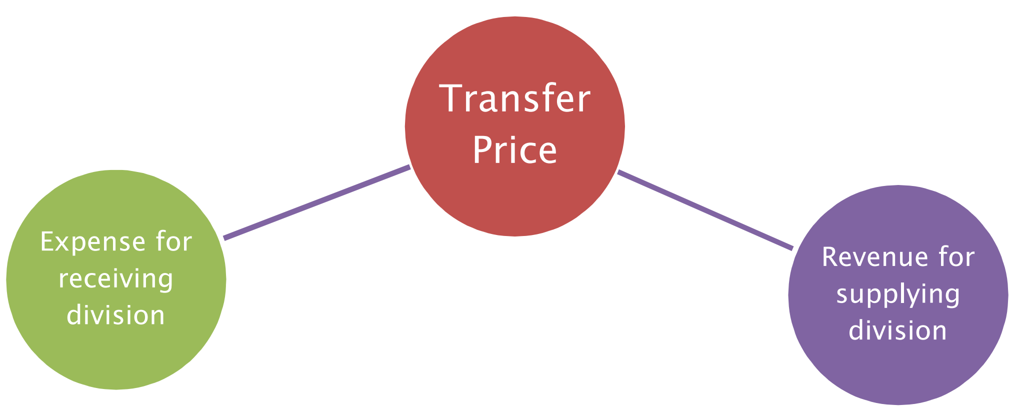
COMPLIANCE PROVISIONS

- The report (Form 3CEB) has to be submitted to the tax authorities by **30th November** which is the due date for filing the annual returns.
- Non-compliance would attract a penalty of-
    - **2% of value of transactions** - In case of failure to maintain required documents, failure to report transactions, providing incorrect information, failure of furnishing documents to tax officer.
    - **Rs.1 lakh** – Failure to furnish form 3CEB before due date

TRANSFER PRICING UNDER COST ACCOUNTING

The transfer price is the price that one division of a company charges another division of the same company for a product transferred between the two divisions.





TWO MAJOR REASONS TO OPERATE A TRANSFER PRICING SYSTEM

- Appropriate transfer prices help to coordinate the production, sales and pricing decisions of the different divisions. Transfer prices make managers aware of the value that the goods and services have to other segments of the firm.
- The use of transfer prices allows the company to generate separate profit figures for each division and thereby to evaluate the performance of each division separately.

METHODS OF COMPUTATION

Market based prices

- Transfer Price is based on Market Price

Cost based prices

- Variable Cost
- Actual Full Cost
- Full Cost Plus Profit
- Standard Cost
- Opportunity Cost

Negotiated prices

- Both the divisions will negotiate for determination of Transfer Prices

DOMESTIC TRANSFER PRICING

OBJECTIVE FOR INTRODUCTION:

The Supreme Court in the case of *CIT Vs. Glaxo SmithKline Asia (P) Ltd.*, in its order has, after examining the complications which arise in cases where fair market value is to be assigned to transactions between domestic related parties, suggested that Ministry of Finance should consider appropriate provisions in law to make transfer pricing regulations applicable to such related party domestic transactions.
Before introduction of Finance bill 2012, unreasonable or excess payment made to related parties or group companies would be disallowed u/s 40A(2)(b) or transfer of goods or services between undertaking claiming deduction u/s 80IA / 80IB and other non claiming deduction undertaking need to be at fair market value. However, the law does not provide any method to determine reasonableness or fair value of expenditure. Hence, finance bill 2012 has introduced "specified domestic transaction" under transfer pricing provisions to determine reasonableness of expenditure or fair market value of transaction.

APPLICABILITY OF PROVISIONS:

The Finance Bill proposes to extend the applicability of the transfer pricing provisions to following referred "specified domestic transactions":

- any expenditure in respect of which payment has been made or is to be made to a person referred to in clause (*b*) of sub-section (*2*) of section 40A;

- transfer of goods or services between business (undertaking/ division) claiming deduction u/s 80C to 80U (includes section 80IA / 80IB) or 10AA (units in SEZ) and other business (undertaking/ division) carried on by the taxpayer.

Minimum value of transactions:

Transfer pricing will be applicable to taxpayer, if aggregate value of all above specific domestic transactions exceeds INR 5 Crores.

UNDERSTANDING TRANSFER PRICING WITH LATEST CASE LAWS

- Difference arose in calculation of cost due to the fact that TPO* took the cost relating to charter hire activity as 50% of total cost whereas the assessee took the actual cost relating to the charter hire activity. Cost plus method can be applied only by taking the actual cost of the activity. Once the figures used in the calculation made by the TPO are replaced by actual figures, the payment made by the assessee is at ALP and, therefore, no adjustment called for. Refer Reliance Industries Ltd. V. Addl. CIT.

*Transfer Pricing Operations

- The assessee has followed a scientific system of providing for depreciation on a more real time basis. The assessee is not providing technical depreciation influenced by Income Tax Rules. The assessee provides for more or less actual depreciation. This actual depreciation is more relevant in working out the operating profit of the assessee. Thus, no adjustment is called for in the quantum of depreciation provided by the assessee in its operating account so as to work out its operating profit for the purpose of determining the ALP. Refer, Lason India Pvt. Ltd. V. Asst. CIT.

- Assessee has reimbursed only cost of one employee who is sitting in Singapore. Assessee has produced evidence in the form of emails to substantiate its case that it has actually obtain services from its group companies and justified the commercial expediency of reimbursement of cost to said concerns by relating the payment to revenue earned by it from such services, the Tribunal held that there is no justification for adjustment to the ALP in respect of the payment made by the assessee to its group concerns. The Tribunal also held that once an international transaction has been made subject to determination of ALP by the TPO, and he has found that transaction is at Arm's Length, then it is not permissible for the AO to reexamine that transaction and make disallowance under the normal provisions of the Act. Refer, Cushman and Wakefield India Pvt. Ltd. V. ACIT.

- Assessee has paid 3% of the Net Sales Price, which was approved by RBI. The Tribunal has found that the assessee had sold only part of goods manufactured to its Associated Enterprise and bulk sales were made to uncontrolled parties, and the AO had failed to bring any material on record to show that payment of royalty at 3% was not at Arm's Length, hence disallowance of royalty was not justified. Refer, SonaOkegawa Precision Forgins Ltd. V. Addl. CIT.