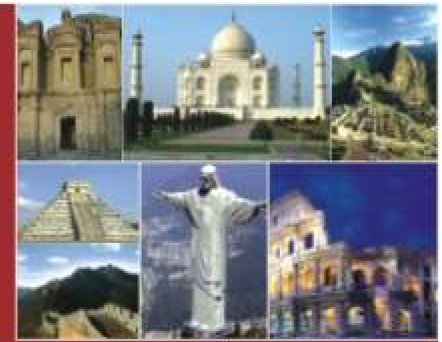
WIRC

WIRC REFERENCE MANUAL 2007-08



TRANSFER PRICING

When independent enterprises deal with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When related enterprise deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associate enterprises often seek to replicate the dynamics of market forces in dealings with each other.

The consideration flow of related enterprise transactions may lead to erosion of tax base even though transfer pricing policies may not be necessarily with that intention.

When transfer pricing does not reflect market forces, the tax revenues of either of the tax jurisdictions could be distorted. Therefore, for tax purposes, tax authorities may adjust the profits of the associate enterprises to correct such distortions and ensure that the country gets its fair share of taxes.

INDIAN TRANSFER PRICING PROVISIONS

Finance Act, 2001 introduced detailed provisions relating to transfer pricing, requiring all 'international transactions' between 'associated enterprises' to be at arm's length. These provisions are applicable with effect from 1st April, 2001. The provisions are comprehensive in many respects and are generally in line with international practices prescribing methodologies and documentation requirements.

SCOPE OF APPLICATION OF THE PROVISIONS

Any income/expense arising from an international transaction with an associated enterprise must be computed having regard to the arm's length price. Also, costs or expenses allocated or apportioned between two or more associated enterprises should be determined having regard to arm's length prices. The transfer pricing provisions are wide enough to cover transactions between a foreign entity and its permanent establishment in India. The transfer pricing provisions would not however apply in cases wherein the application of the arm's length price results in a downward revision in the income chargeable to tax in India.

INTERNATIONAL TRANSACTIONS

- The term covers a wide range of revenue and capital transactions between two or more associated enterprises where either or both are non-residents;
- The term also includes arrangements between associated enterprises for cost sharing in connection with benefits, services or facilities provided to any of such enterprises.

Additionally, under certain circumstances transactions between two unrelated entities can be deemed to be international transaction This is when an enterprise, say X Ltd., has entered into a transaction with an unrelated person, say A Ltd. and there exists a prior agreement in relation to this transaction between A Ltd. and Y Ltd. (an associated enterprise of X Ltd.); or the terms of this transaction (i.e., the transaction between X Ltd. and A Ltd.) are determined in substance between A Ltd. and Y Ltd.

ASSOCIATED ENTERPRISE

The term 'Associated Enterprise' has been defined in a broad manner based on the criteria of direct or indirect participation in the management, control or capital of the other enterprise or by the same persons in such enterprise. The regulation gives illustrative list of relationships to which transfer pricing rules apply: equity holding of 26%; control of board of directors; loans/guarantees; dependence on the use of specified intangibles of the other enterprise; influence over supply of raw material/finished products.

COMPUTATION OF ARM'S LENGTH PRICE

The arm's length price in relation to an international transaction is to be determined using the most appropriate method out of the specified methods, having regard to the nature or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as may be prescribed. The five specified methods are:

- Comparable Uncontrolled Price Method ('CUP');
- Resale Price Method ('RPM');
- Cost Plus Method ('CPLM');
- Profit Split Method ('PSM'); and
- Transactional Net Margin Method ('TNMM')

Though the provisions allow for use of any other method as the Central Board of Direct Taxes may prescribe, no other method has been prescribed till date.

USE OF MULTIPLE YEAR DATA

It is pertinent to note that the regulations prescribe that the data used in comparing the uncontrolled transaction with the international transaction should relate to the same financial year in which the international transaction was entered into.

However, if the previous years' data reveals facts that could have an influence on the determination of transfer prices in relation to the international transactions being compared, then, data relating to a period of up to two years prior to the financial year in which the international transaction is carried out could be considered.

ARITHMETIC MEAN

The provisions specify that where more than one price is determined by the most appropriate method, the arm's length price shall 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.

The concept of Arithmetic Mean in the Indian Regulations is a unique feature not commonly found in similar legislations of other countries, which generally place reliance on the 'inter-quartile range' concept.

REFERENCE TO TRANSFER PRICING OFFICER

The Assessing Officer, if he considers necessary, may refer the computation of the arm's length price in relation to any international transaction to the Transfer Pricing Officer, with the previous approval of the Commissioner.

The Transfer Pricing Officer shall determine the arm's length price and send a copy of his written order to the Assessing Officer and to the tax-payer. The Assessing Officer will compute the tax-payer's income having regard to such arm's length price.

DETERMINATION OF ARM'S LENGTH PRICE AND COMPUTE TOTAL INCOME

If, in the course of assessment proceedings, the Assessing Officer or Transfer Pricing Officer, on the basis of material or information or document in his possession, is of the opinion that:—

- the price charged or paid in an international transaction has not been determined based on the methods prescribed and the arithmetic mean as discussed aforesaid; or
- any information or document relating to an international transaction has not been maintained as prescribed; or
- the information or data used in computation of the arm's length price is not reliable or correct; or
- the tax-payer has failed to furnish any information or document within the specified time as required,

he may determine the arm's length price in accordance with the methods prescribed and on the basis of such material or information or document available with him, compute the tax-payer's income accordingly. Where the Assessing/Transfer Pricing Officer determines an arm's length price, *and* computes the total income of the tax-payer having regard to the arm's length price so determined, no tax benefits under section 10A, 10AA or 10B or under Chapter VI-A of the Act will be allowed in respect of the amount of income by which the total income of the tax-payer is enhanced after such computation by the Assessing Officer.

NO ADJUSTMENT TO ASSOCIATED ENTERPRISE'S INCOME

In cases where the total income of a tax-payer is re-computed after determination of the arm's length price paid to another associated enterprise from which tax has been deducted or was deductible at source, the income of the other associated enterprise shall not be recomputed by reason of such re-determination of arm's length price in the case of the tax-payer.

STATUTE OF LIMITATIONS ON ASSESSMENT

Statute of limitation for transfer pricing adjustments is forty five months from tax year end. This is in contrast to normal assessments wherein the statute of limitation is thirty three months. The need for additional period was felt as transfer pricing is an intensive fact finding exercise that requires additional time and resources.

DOCUMENTATION

Every person who has entered into an international transaction with an associated enterprise would be required to maintain certain primary information and documentation. Such primary documentation need not be maintained in cases where the aggregate book value of international transactions entered into by the tax-payer does not exceed rupees ten million. However, in such cases, the tax-payer would need to substantiate, on the basis of material available with him, that income arising from international transactions entered into by him has been computed in accordance with the arm's length principle.

RELAXATION OF REQUIREMENT TO MAINTAIN FRESH DOCUMENTATION

It is prescribed that in cases wherein an international transaction continues to have effect over more than one financial year, fresh documentation need not be maintained separately in respect of each financial year, unless there is any significant change in the nature or terms of the international transaction, in the assumptions made, or in any other factor which could influence the transfer price. In case there is a significant change, fresh documentation shall be maintained bringing out the impact of the change on the pricing of the international transaction.

PERIOD OF MAINTENANCE OF DOCUMENTATION

Though the regulations recommend contemporaneous maintenance of documentation, it is also prescribed that the documentation should be maintained latest by 31st October following the financial year in case of companies and persons whose accounts are required to be audited under Income-tax Act (Tax Audit) or any other Act and 31st July following the financial year in other cases.

The specified information and documents are required to be maintained for a period of eight years from the end of the relevant assessment year.

ACCOUNTANT'S REPORT

It is prescribed that every person who has entered into an international transaction shall obtain a report from an independent practising Chartered Accountant. This Report (Form No. 3CEB) should be furnished to the Income Tax department before the due date of filing the return. The Report gives particulars of associate enterprises, international transactions, arm's length price and the method used for determining arm's length price.

PENALTIES

The provisions have prescribed levy of penalties for non-compliance with the statutory requirements, as follows:

- Failure to maintain prescribed documentation could attract penalty at the rate of 2% of the value of each international transaction.
- Failure to furnish documentation required by the tax authorities could lead to a penalty at the rate of 2% of the value of each international transaction.
- Failure to furnish the prescribed report of the accountant can attract penalty of one hundred thousand rupees.

In the above cases if the tax-payer can prove to the satisfaction of the tax authorities that he had reasonable cause for not complying with the relevant statutory requirements, no penalty can be levied.

If tax authorities makes an adjustment to the income of the tax-payer by re-determining the transfer pricing for an international transaction entered into by the tax-payer with its associated enterprise, such adjustment to the income would be treated as concealed income of the tax-payer and would be taxed accordingly. Moreover, the tax-payer in such a case, would be subjected to a penalty ranging from 100% to 300% of tax payable on the additional income or the disallowance made by the officer. However, penalty would be mitigated if the tax-payer can prove to the satisfaction of the tax authorities, that the price charged or paid in such transaction was computed in accordance with the transfer pricing provisions in good faith and with due diligence.

FLOW CHART OF TRANSFER PRICING REGULATION

1. Determine whether Associated enterprise (AE) - S. 92A

2. Determine whether International Transaction – S. 92B

3. In case of International Transaction with AE Transfer Pricing Study is needed

4. Study Involves:
   - comparability with uncontrolled transaction
   - selecting & applying Most Appropriate Method (MAM)
   - determination of arm's length price -S. 92C

5. Factors affecting comparability – Rule 10B(2)
   - specific characteristics of property/services
   - functions performed, risk assumed
   - contractual terms of the transactions
   - conditions prevailing in the market (including geographical location, size of the market etc.)

6. Factors affecting selection of MaM -Rule 10(C)
   - the nature and class of international transaction
   - class of A.Es and functions performed, assets employed and risk assumed by them
   - availability, coverage and reliability of data
   - the degree of comparability existing between International Transactions and Uncontrolled Transactions
   - the extent to which reliable and accurate adjustments can be made.
   - the nature, extent and reliability of assumptions required to made in application of method