TRANSFER PRICING

INDEX

1. DEFINITIONS :

- **International transaction**

'International transaction' means any of the following nature of transactions between two or more "Associated enterprise" where, either or both of whom are non-residents In other words if both or all the enterprises executing the transaction are residents, then it is not an "International Transaction" for the purpose of these provisions

(a) purchase,

(b) sale,

(c) lease of tangible or intangible property,

(d) provision of services,

(e) lending or borrowing money, or

(f) any other transaction having a bearing on the profits, income, losses or assets of such enterprise.

International Transaction matrix :

Transaction By	Transaction With	
	Resident	Non - Resident
Resident	X	✓
Non - Resident	✓	✓

✓ - Considered as International Transaction.
X - Not Considered as International Transaction.

- **ARM'S LENGTH PRICE**

'Arms length price ' means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

- **ASSOCIATED ENTERPRISE**

ASSOCIATED ENTERPRISES

MANAGEMENT	CAPITAL	CONTROL
Appointment of more than half of Board of Directors/ Board of Members/ one or more Executive Directors/ Executive Members by : - The other Enterprise - The same person(s) in both the enterprises.	Holding not less than 26% of the voting power directly or indirectly - in the other enterprise - in each of such enterprise	- Loan not less than 51% of Book value of Total Assets - Guarantee not less than 10% of Total borrowings - Use of Knowhow, patents, copy right, etc., of which other enterprise is owner or has exclusive rights - Purchase of 90% or more Raw Materials and Consumables for which prices and other conditions are influenced - Sale of goods manufactured or processed to other enterprise or person specified by it for which prices and other conditions are influenced - Control by same person

***Note** : Apart from the above, any relationship of mutual interest, as may be prescribed shall also be considered as Associated enterprise.*

2. <u>Determination of Arm's Length Price:</u>

The income arising from an international transaction is required to be computed having regard to the arm's length price. Section 92F(ii) defines arm's length price as 'a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.'

Thus, the definition provides that a price at which independent enterprises deal with each other (which is ordinarily determined by market forces), should be reckoned as the arm's length price.

The provisions relating to determination of arm's length price are contained in section 92C which provides as follows: The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transactions or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely:

(a) Comparable uncontrolled price method

(b) Resale price method

(c) Cost plus method

(d) Profit split method

(e) Transactional net margin method

(f) Such other method as may be prescribed by the Board

- **Comparable uncontrolled price method :**

In this method, price charged in an uncontrolled deal between comparable entities is recognized and evaluate with the verified entity price to determine the Arm's Length Principle.

The CUP method offer the finest evidence of ALP. A arm's length price may arise where:

- Tax payer or another member of the associate group sells the product, in comparable sizes and in the comparable terms to ALP in similar promote markets (internal comparable).

- An ALP party sells the similar product, in similar size of quantity and in the comparable conditions to other arm’s length party in similar markets (an external comparable).

- The taxpayer of the entities buys the similar quantities, in comparable quantities and in the similar terms from the associate parties in the comparable markets (internal comparable).

- An ALP party buys the particular goods, in comparable quantities and in the similar terms from the other arm’s length associate party in similar markets (external comparable).

- **Resale price method :**

RPM method is related to CPM. This method is used where the vendor adds similarly little value to goods owned from associate enterprises. Here, Arm’s Length Price is determined by reducing the relevant gross profit mark-up from the sale price charged to free entity.

The resale price method starts with the resale price to arm's length entities (of a goods buy from an non-arm's length entities), minimized by a similar gross margin. This similar gross margin is resolute by reference to either:

- The resale price margin earned by a associate of the group in similar uncontrolled transactions (internal comparable); or

- The resale price margin earned by an arm's length enterprise in similar uncontrolled transactions (external comparable).

Beneath this method, the arm's length price of products obtain by a taxpayer in a non-arm's length deal is resolute by reducing the price understand on the resale of the products by the taxpayer to an arm's length entities, by an suitable gross margin. This gross margin, the resale margin, should allow the vendor to:

- Recover its operating costs; and

- Earn an arm's length profit support on the factors achieve, properties used, and the risks understood.

- **Cost plus method :**

In this method, the total price of intangible incurred by the tested parties in transferring products and services to Associated Enterprises is measured and the sum of gross profit spot used by similar enterprises in comparable transactions with self-determining associated enterprises is determined. The sum of gross spot arrived at is used to take into account functional and other variation to determine ALP. The extra similarities in the functions, risks and property, the extra likely it is that the cost plus method will create an suitable estimation of an arm's length result.

In common, for reason of apply a cost-based method, costs are divided into three categories:

- Direct costs:- raw materials;
- Indirect costs:- repair and maintenance which may be allot among several goods.
- Operating expenses:- selling, general, and organizational expenses.

The cost plus method uses limits calculated after direct and indirect costs of goods. Correctly shaping cost under the cost plus method is important. Cost is typically calculated in agreement with accounting values that are usually accepted for that exacting industry in the region where the products are produced.

The cost base of the deal of the associated parties to which a mark-up is to be applied be calculated in the same way and returns comparable functions, risks, and properties as the cost base of the similar transactions. Where cost is not exactly resolute in the same way, both the mark-up and the transfer will be used.

- **Profit Split method :**

This method is used when associate enterprise transactions are included that it becomes very hard to conduct a transfer pricing analysis on a transactional base. The priority function to do is combined net profit acquiring to connected entities from a transaction is decide. After that combined net profit is allotted in between connected entities with mention to market income gained by free enterprises in comparable transactions.

In this Profit Split Method (PSM):

- First move is to decide the sum of profit gained by the associate parties from a controlled transaction. The Profit Split Method (PSM) allots the total incorporated profits connected to a controlled transaction, not the total profits of the associate group as a complete. The profit to be split is usually the operating profit, before the reduce of interest and taxes. In some satiations, it may be suitable to split the gross profit.

- Second move is to split the profit among the associate parties base on the comparative price of their assistance to the non-arm's length dealings, allowing for the functions assumed, the properties used, and the risks understood by each non-arm's length associate parties, in connection to what arm's length parties would have taken.

Profit Split Method (PSM) applied where:

- The functioning of two or more non-arm's length associate parties are extremely included, making it hard to assess their dealings on an entity basis; and

- The continuation of valuable and sole intangibles makes it hard to set up the proper stage of comparability with uncontrolled dealings to relate a one-sided method.

Due to the difficulty of international operations, one group of the global group is rarely allowed to the total return attributable to the important properties, such as intangibles.

- **Transaction Net Margin Method :**

Generally accepted in cases of transfer of semi-completed products, distribution of completed goods and transactions linking the condition of services.

In this method:

- Relatively the net profit margin of a entities take position from a non-arm's length deal with the net profit margins understand by arm's length associate parties from comparable transactions; and

- Observe the net profit margin relation to suitable base such as price, sales or properties.

This vary from the cost plus and resale price methods that balance gross profit margins. though, the TNMM need a stage of similarity to that necessary for the request of the cost plus and resale price methods. Where the applicable information exists at the gross margin stage, associate enterprises should apply the cost plus or resale price method.

3. Selection of the most appropriate method:

Selection of most appropriate method shall be adopted having regard to the nature of transaction or class of associated persons or functions performed by such persons or such other relevant factors. The following factors shall be taken into account.

- The nature and class of the international transactions;
- The class or classes of associated enterprise entering into the transaction and the function performed by them taking into account assets employed or to be employed and the risks assumed by such enterprises;
- The availability, coverage and reliability of data necessary for application of the method:
- The degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprise entering into such transaction;
- The extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transaction;
- The nature, extent and reliability of assumptions required to be made in application of a method.

4. Choice of Most Appropriate Method :

Even though it is not possible to standardize the selection of most appropriate methods , the following can be stated as suggestive guideline ;

- **Comparable uncontrolled price method** is relevant in case of transaction of loans, royalties, services, transfer of tangibles.

- **Resale price method** is relevant in case of marketing operations of finished products more particularly in case of distribution of products not involving significant value addition. In this method the vendor adds comparatively small or no value to goods taken from associate enterprises.

- **Cost plus method** is more relevant where raw materials or semi finished products are sold. Similarly, it can also be used where joint facility agreements or long term buy and supply arrangements or provisions of services are involved

- **Profit split method** is relevant where the transactions involved provision of integrated services by more than one enterprise. 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 marginal method** is used in most of the cases including transfer of semi-finished goods, distribution of products where resale price method appears to be inappropriate and also in case involving provision of services.

5. Maintenance. Keeping of information and documents :

Every person who has entered into an Internal transaction shall keep and maintain the following information and documents, vide Rule 10D, in respect thereof;

- A description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises;
- A profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them;
- A broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted;
- The nature and terms (including prices)of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;
- A description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction;
- A record o the economic and market analysis, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee;
- A record of uncontrolled transactions taken into account for analyzing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;
- A record of the analysis performed to evaluate comparability to uncontrolled transactions with the relevant international transaction;
- A description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case;

- A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;

- The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;

- Details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes;

- Any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.

- **Supporting Documents:**

- official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;

- reports of market research studies carried out and technical publications brought out by institutions of national or international repute;

- price publications including stock exchange and commodity market quotations;

- published accounts and financial statements relating to the business affairs of the associated enterprises;

- agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;

- letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;

- documents normally issued in connection with various transactions under the accounting practices followed.