What is Transfer Pricing?

Usually there is a tendency among MNCs to adjust their international transactions in such a way that **maximum profit arises in that country where the rate of tax is lowest and minimum profit arises in that country where the rate of tax is highest.** This creates the problem of transfer pricing. Thus there may be chances that MNC escape tax in those countries where the tax rate is more by adjusting their international transaction and declaring lesser profits in such country. This can be explained with an example:

Suppose a subsidiary company, resident in country A (which has a tax rate of, say, 30%) manufactures goods and transfers them to its parent company in country B (which has a tax rate of 20%) for trading. In order to increase the overall profits of the group company, it will seek to supply the goods at prices which are lower than the market price. So, in effect, the subsidiary company in country A will have lower profits and hence, a lower tax incidence whereas the parent company in country B is affected in the opposite manner higher profits due to low costs, but lower taxes because of the tax rate.

The law requires that goods and services should be sold to subsidiary companies at **arm's length price** -- the price at which goods are traded between unconnected companies.

In order to cover such tendencies of MNCs section 92A to 92F have been enacted and section 271AA, 271BA and 271G have been incorporated and section 271 has been amended providing for penal provisions in this regard.

How the income from international transactions will be computed?

As per section 92 any income from international transaction shall be computed as per arm's length price. Any allowance of interest or expenses with respect to the above income shall also be computed having regard to arm's length price.

Further where, in an international transaction, two or more associated enterprises enter into a mutual agreement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided or apportioned to or as the case may be, contributed by, any such enterprises shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.

In simple words it means that **not only the income from an international transaction is to be computed as per arm's length price but also any expense or cost** to be incurred in an international transaction in connection with a benefit or service or facility to be provided will be computed as per arm's length price.

Section 92 also provides that its **provisions shall not apply where it has effect of reducing the income chargeable to tax or increasing the loss,** as the case may be, computed on the basis of enteries made in the books of account in respect of the previous year in which the international transaction was entered into.

Now the question arises about the meaning of some of the concepts as mentioned above like International transactions, associated enterprises and arm's length. These can be discussed as follows:

What is an International Transaction?

To apply the provisions related to transfer pricing as contained u/s 92, 92A to 92F **there must be an international transaction**.

*As per section 92B an international transaction means a transaction between two or more **associated enterprises, either or both of whom are non-resident** and such transaction is in the nature of purchase, sale or lease of tangible or intangible property or provision of services, or lending or borrowing money or any other **transaction having a bearing on the profits, income, losses or assets of such associated enterprises**.*

Further section 92B provides that, where a **transaction entered into by an enterprise with a person other than an associated enterprises and there exist a prior agreement** in relation to the relevant transaction **between such other person and associated enterprise,** or the terms of the relevant transaction are determined in substance between such other person and the associated enterprises then such transaction **shall also be treated as an international transaction**.

What is associated Enterprises?

To apply the provisions relating to transfer pricing there must also be associated enterprises. Which enterprises can be termed as associated enterprises can be known u/s 92B. As per section 92B(i) the associated enterprises in relation to another enterprise is:

(a) which participates, directly or indirectly, or though one or more intermediateries, in the **management or control or capital** of other enterprise; or
(b) in respect of which, one or more persons who participate directly or indirectly or through one or more intermediateres, in its management or control or capital, are the same persons who participate, directly or indirectly or through one or more intermediataries, in the management or control or capital of the other enterprise.

Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,-

(a) One enterprise holds, directly or indirectly, **shares carrying not less than 26 per-cent of the voting power** in the other enterprise; or
(b) Any person or enterprise holds, directly or indirectly, shares carrying not less than 26 per-cent of the voting power in each of such enterprises; or
(c) A **loan advanced** by one enterprise to the other enterprise constitutes **not less than 26 percent of the book value of the total assets** of other enterprise; or

(d) One enterprise **guarantees not less than 10 per-cent of the total borrowings** of the other enterprise; or

(e) More than half of the **board of directors or members** of the governing board, or one or more of the executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise;

(f) More than half of the board of directors or members of the governing board, or one or more of the executive directors or executive members of the governing board of each of the two enterprises are appointed by the same person or persons; or

(g) The manufacture or processing of goods or articles or business carried out by one enterprise is **wholly dependent on the use of know-how, patents, copyrights, trademarks, licences, frenchises or any other business or commercial rights of similar nature,** or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise is the owner or in respect of which the other enterprise has executive rights; or

(h) **90 per cent or more of the raw materials and consumables** required for the manufacture or processing of goods or articles carried out by one enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

(i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

(j) where one enterprise is **controlled by an individual**, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

(k) where one enterprise is controlled by a **Hindu undivided family**, the other enterprise is also controlled by a member of such HUF or by a relative of a member of such HUF or jointly by such member and his relative; or

(l) where one enterprise is a firm, **association of persons or body of individuals**, the other enterprise holds not less than 10 percent interest in such firm, association of person or body of individual.

(m) There exists between the two enterprises, any **relationship of mutual interest**, as may be prescribed.

What is arm's length price?

As stated above the income from an international transaction is computed as per arm's length price. Arm's length price has been defined in section 92F(ii) as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

The arm's length principle suggests that the associated enterprises should be treated as independent enterprises and international transaction is considered at the market price.

As per section 92C the arm's length price in relation to an international transaction shall be determined by any of the prescribed methods discussed as below:

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Comparable Uncontrolled Prices method (CUP): Under this method, *price charged in an uncontrolled transaction between comparable entities is* identified and compared with the tested entity price (after making due adjustments in relation to terms and conditions and risk involved) to determine the ALP.

Cost Plus Method (CPM): Here, the total cost of production incurred by the enterprise in question in transferring goods and services to Associated Enterprises (AEs) is calculated and the total *gross profit mark up used by comparable entities* in similar transactions with independent enterprises is determined. The total gross mark-up arrived at is adjusted to take into account functional and other differences and is added to the costs calculated to determine ALP.

Resale Price Method (RPM): Under this method the *price at which property or services in question are resold or provided to an unrelated enterprise* is identified. Such resale price is reduced by the normal gross profit accruing to an enterprise in a comparable uncontrolled transaction.

Profit Split Method (PSM): PSM is used when AEs transactions are so integrated that it becomes impossible to conduct a TP analysis on a transactional basis. First, the *combined net profit* incurring to related enterprises from a transaction is determined. Then, the combined net profit is allocated between related enterprises with reference to market returns achieved by independent entities in similar transactions. The relative contribution of related parties is then evaluated on the basis of assets employed, functions performed or to be performed and risk assumed.

Transactional Net Margin Method (TNMM): TNMM is normally adopted in cases of transfer of semi-finished goods, distribution of finished products (where resale price method (RPM) cannot be adequately applied) and transactions involving the provision of services. TNMM compares the *net profit margin relative to an appropriate base (sales, assets or costs incurred) of the tested party with net profit margin of the independent enterprises in similar transactions after making adjustments.*

Any other method as may be prescribed by the Board.

The **most appropriate method of all the above methods should be applied** in determining arm's length price depending upon various factors like nature of transaction availability of information etc.

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.

Actual price at which international transaction has been undertaken shall be accepted where the **variation with the arm's length price does not exceed 5 percent.**

Section 92CB provides that w.r.ef asst. year 2009-10 Income tax authorities will accept the transfer price declared by the assessee provided they are in accordance with the Safe Harbour Rules to be notified by CBDT. safe Harbour means circumstances in which the income tax authorities shall accept the transfer price declared by the assessee.

When the assessing officer can determine arm's length price?

As per section 92C(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, **on the basis of material or information or document in his possession**, of the opinion that—
(a) the price charged or paid in an international transaction has not been determined in accordance with the prescribed manner; or
(b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or
(c) the information or data used in computation of the arm's length price is not reliable or correct; or
(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,
the Assessing Officer may proceed to determine the arm's length price in relation to the said international transaction on the basis of the information or material available.

Procedure to be followed by the assessing officer while determining arm's length price:

Proviso to section 92C(3) provides that an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arm's length price should not be so determined on the basis of material or information or document in the possession of the Assessing Officer.

The Finance Act 2002 has inserted a new section 92CA according to which in case of international transaction, the A.O may refer the matter to Transfer Pricing officer, if he considers it necessary or expedient to do so, with the prior approval of commissioner, for the purpose of computing arm's length price.

The following procedure will be followed by TPO while determining ALP:

(1) Where a reference is made to the TPO, the Transfer Pricing Officer shall serve a notice on the assessee requiring him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the arm's length price in relation to the international transaction in question.

(2) On the date specified in the notice , or as soon thereafter as may be, after hearing such evidence as the assessee may produce, including any information or documents referred to in sub-section (3) of section 92D and after considering such evidence as the Transfer Pricing Officer may require on any specified points and after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall, by order in writing, determine the arm's length price in relation to the international transaction and send a copy of his order to the Assessing Officer and to the assessee.

(3) On receipt of the order under from TPO, the Assessing Officer shall proceed to compute the total income of the assessee in conformity with the arm's length price as so determined by the Transfer Pricing Officer.

The obligations of an assessee having international transactions:

The obligation of an assessee having international transaction are as follows:
(1) The income from the international transaction should be computed as per arm's length price
(2) Every person who has entered into an international transaction shall keep and maintain such information and document in respect thereof and for such period, as may be prescribed by the board and produce before the A.O or commissioner (Appeals) as and when required in the cource of proceedings under Income Tax Act within a period of 30 days from the date of receipt of notice.
(3) The assessee entering into an international transaction is also required to firnish an audit report in the form 3CEB by a chartered accountant by 31st of October of relevant A.Y where the assessee is a company and by 31st day of july in other cases.

Penal provisions:

As per section 271AA if the required information and documents are not maintained, the A.O or CIT(A0 may impose a penalty of a **sum equal to 2% of the value of such international transaction**. Similar penalty is provided u/s 271G if the assessee fails to furnish the documents requisitioned by the A.O or CIT(a).

Section 271BA provides that if an assessee fails to furnish the report of Chatered accountant as required u/s 92E, the A.O may impose penalty of **Rs. 1 Lakh**.

Explanation 7 to section 271(1)(c) provides that where in the case of an assessee who has entered into an international transaction defined in section 92B, any amount is added or disallowed in computing the total income under section 92C(4) then, the amount so added or disallowed shall, for the purpose of section 271(1)(c), be deemed to represent the income in respect of which particulars have been concealed or inaccurate particulars have been furnished.
However the explanation does not apply where the assessee proves to the satisfaction of the A.O or the CIT that the price charged or paid in such transaction has been determined in accordance with section 92C in good faith and with due diligence.

As per section 273B no penalty will be levied u/s 271AA, 271BA, 271G where it is proved that there was a reasonable cause for the failure.