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Introduction

MEANING

Transfer pricing is simply the act of pricing of goods and services or intangibles when the same is given for use or consumption to a related party (e.g. Subsidiary). There can be either Market-based, i.e. equivalent to what is being charged in the outside market for similar goods, or it can be non-market based. Importantly, two-thirds of the managers say their transfer pricing is non-market based. There can be internal and external reasons for transfer pricing. Internal include motivating managers and monitoring performance, e.g. by putting a cost to imported inputs. External would be taxes and tariffs.

Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms. One party transfers to another goods or services, for a price. That price is known as transfer price. This may be arbitrary and dictated, with no relation to cost and added value, diverge from the market forces. Transfer price is, thus, a price which represents the value of good; or services between independently operating units of an organization. But, the expression transfer pricing generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities. It also refers to the value attached to transfers between unrelated parties which are controlled by a common entity.

Suppose a company ABC purchases goods for 100 rupees and sells it to its associated company XYZ in another country for 200 rupees, who in turn sells in the open market for 400 rupees. Had ABC sold it direct, it would have made a profit of 300 rupees. But by routing it through XYZ, it restricted it to 100 rupees, permitting XYZ to appropriate the balance. The transaction between ABC and XYZ is arranged and not governed by market forces. The profit of 200 rupees is, thereby, shifted to the country of XYZ. The goods are transferred on a price (transfer price) which is arbitrary or dictated (200 hundred rupees), but not on the market price (400 rupees).

Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. As an example of this, a group which manufactures products in high tax countries may decide to sell them at a low profit to its affiliate sales company based in a tax haven country. That company would in turn sell the product at an arm's length price and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves

TRANSFER PRICING MANIPULATION

This leads us to the point of Transfer Pricing Manipulation (TPM). It is TPM that is discouraged by Governments as against Transfer Pricing which is the act of pricing. However, in common parlance, it is Transfer Pricing which is generally used to mean TPM.

TPM is fixing transfer price on non-market basis which generally results in saving the total quantum of organization's tax by shifting accounting profits from high tax to low tax jurisdictions. The implication is moving of one nation's tax revenue to another. A similar phenomenon exists in domestic markets where different states attract investment by under cutting Sales tax rates, leading to outflow from one state to another, something the Government is trying to curb by way of implementation of VAT.

MOTIVATIONS FOR TPM

It is not just the Corporate Tax differential that induces organizations to manipulations in Transfer Pricing. Some of the other reasons are:

- High Customs Duty – leading to under-invoicing of goods.
- Restriction on Profit Repatriation – leading to over-invoicing of raw materials, etc transferred from parent country, hence compensating for locked forex.
- Ownership Restrictions (E.g. Insurance Sector – 26%) – since this leads to less than justified returns on the technology or knowledge invested in the JV, MNEs circumvent it through over charging on royalties for technology, etc.

There can be various other similar motivations for TPM. The transactions most likely disputed by Governments are Administration & Management Fees, Royalties for intangibles and transfer of finished goods for resale. (Source: E & Y Survey)

EFFCECTS OF TPM ON NATIONS

1) One primary and well appreciated effect is the loss of Government Tax and Custom Duty revenues. Loss of tax revenues in this form leads to a burden on the rest of the population through over taxation and/or borrowings by the Government, which becomes essential to meet expenditure requirements.
2) TPM also leads to distortions in Balance of Payments between the host and home country, something that has the potential to challenge the sovereignty of nations given the mega size of some of these firms.
3) Another implication is on the location of international production and employment. Given the objective of maximization of global profits, MNEs will open subsidiaries where production is most profitable, which is where tax burden is less and therefore effect the level of FDI a country gets. This linkage is so strong that some like Hong Kong and Singapore have no Transfer Pricing controls, making themselves attractive destinations for FDI.
4) Transfer Pricing has been existing in domestic and importantly international transactions over decades now and there is nothing novel about the concept. What is, however, is the extent of this practice which has now acquired critical mass to be given due consideration by various tax authorities.

TPM GAINING IMPORTANCE

The issue has gained importance in the recent past due to organizations acquiring huge economic power (in some cases more than nations themselves - Of the 100 biggest economies, 51 are companies and 49 are countries) operating in scores of nations, making their sales, production and distribution structure more and more complex to come under the purview of one tax regime.
The other phenomenon is increasing liberalization due to which a larger number of countries are allowing entry of these MNEs and a further larger number making their environment conducive for foreign investment. This has led to establishment of truly global corporations resulting in a higher proportion of intra organization

trade in international trade. To substantiate the idea further, one-thirds of total world trade is intra-firm.

A third phenomenon, particularly in countries like India, is one of Government moving away from control of productive resources (by way of divestment, etc.) which has put all the more emphasis on tax revenues in meeting Govt.'s revenue requirements.

CHECKING TRANSFER PRICING MANIPULATION

Having understood the implications and growing importance of Transfer Pricing, more precisely Transfer Pricing Manipulation, we look at what regulations have been enacted to counter this by India.

TRANSFER PRICING REGIME IN INDIA

In India a new transfer pricing regime has been introduced the year 2001 by the Finance Act 2001. Earlier a limited provision (Section 92) existed in the Income tax Act, which provided for making adjustment to the income of a resident taxpayer from a transaction with a non resident if the Assessing Officer was of the view that the income from such a transaction was understated in the hands of the resident due to the close connection between the two. No other rules or obligations about maintenance of documents about such transaction existed under the old Section 92 which remained in the statute for a number of years though it was almost never invoked in practice. The Finance Act 2001 has substituted a new section 92 and inserted sections 92A to 92F and certain other provisions in the Income tax Act which provide the statutory backbone of the new transfer pricing law. The procedural rules under these sections have been inserted in the Income tax Rules, by Notification S.O 808 (E) dated 21 August, 2001.

The new transfer pricing regime requires compliance with the principle of arm's length price in cases involving an 'international transaction' between associated enterprises (Section 92). The term 'associated enterprise' is defined in Section 92A which provides 13 parameters to determine if the enterprises concerned would constitute 'associated enterprises'. Section 92B defines the term 'international transaction' as a transaction between two or more associated enterprises when either or both them are non resident.

The transactions covered are transfer of tangibles, intangibles, services, lending and borrowing of capital and cost contribution agreements. Section 92 C lays down five methods for the determination of arm's length price. These are same as the transaction methods prescribed in the OECD guidelines viz. comparable uncontrolled price method, resale price method, cost plus method, profit split method and transaction net margin method. Section 92C also lays down the provisions relating to transfer pricing audit which may be triggered if the administration is of the opinion that the transfer price adopted does not reflect arm's length price, or if proper information or documents are not maintained. Provisions have also been made in respect of penalties for concealment of income by adopting non arm's length price, defaults relating to maintenance of prescribed information and documents and failure to furnish required information or documents during an audit or appellate proceedings.

PROVISIONS OF THE INCOME TAX ACT, 1961

Relevant Definitions

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.

Enterprise

Enterprise means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, licenses, franchises 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 has exclusive rights, or the provision of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places;

Permanent Establishment

Permanent Establishment, referred to in clause (iii) of section 92F, includes a fixed place of business through which the business of the enterprise is wholly or partly carried on;

Transaction

A transaction includes an arrangement, understanding or action in concert, whether or not such arrangement, understanding or action is formal or in writing; or whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

Meaning of International transaction

For the purposes of section 92B and sections 92, 92C, 92D and 92E, international transaction means a transaction between two or more associated enterprises, either or both of whom are non-residents, 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 enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises 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 to any one or more of such enterprises.

A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

Meaning of Associated enterprise

92A associated enterprise, in relation to another enterprise, means an enterprise

- which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

IMPORTANT PROVISIONS

Reference to Transfer Pricing Officer

92CA Where any person, being the assessee, has entered into an international transaction in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arms length price in relation to the said international transaction under section 92C to the Transfer Pricing Officer.

Maintenance and keeping of information and document by persons entering into an international transaction

92D. (1) Every person who has entered into an international transaction shall keep and maintain such information and document in respect thereof, as may be prescribed23.

(2) Without prejudice to the provisions contained in sub-section (1), the Board may prescribe the period for which the information and document shall be kept and maintained under that sub-section.

(3) The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceeding under this Act, require any person who has entered into an international transaction to furnish any information or document in respect thereof, as may be prescribed under sub-section (1), within a period of thirty days from the date of receipt of a notice issued in this regard:

Provided that the Assessing Officer or the Commissioner (Appeals) may, on an application made by such person, extend the period of thirty days by a further period not exceeding thirty days.

Report from an accountant to be furnished by persons entering into international transaction

92E. Every person who has entered into an international transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed

COMPUTATION OF ARMS LENGTH PRICE

As per the provisions of section 92C the arms length price (ALP) 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 transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe

- Comparable Uncontrolled Price Method ("CUP")
- Resale Price Method ("RPM")
- Cost Plus Method ("CPM")
- Profit Split Method ("PSM")
- Transactional Net Margin Method ("TNMM")
- Any other method prescribed by the Central Board of Direct Taxes (CBDT)

There are clearly some roadblocks in implementation of ALP, like:

- Specialized nature of goods/ services and uniqueness of intangibles
- Independent entities might not undertake similar transactions, because of copyright issues. For e.g. Coke would only share its formula with a related party where it has some stakes.
- There is a huge administrative burden on part of tax authorities in determining the true transfer price and this exercise might sometime take years, by when the situation changes dramatically
- Confidentiality issue may restrict availability of comparable information.

IMPORTANT RULES UNDER INCOME-TAX RULES, 1962

Rules 10A to 10E provide the framework for implementation of Sections 92 to 92F. The following aspects are covered by the Rules:

⇒ *Rule 10A* defines certain expressions;
⇒ *Rule 10B* provides for the manner in which arm's length price would be determined applying the prescribed methods;
⇒ *Rule 10C* lays down the factors to be considered in selecting the most appropriate method;
⇒ *Rule 10D* prescribes information and documents, which are required to be maintained; and
⇒ *Rule 10E* lays down the format of the report to be obtained from an Accountant.

Rule 10A

It defines the terms:

- "Uncontrolled transactions" as being transactions between enterprises other than Associated Enterprises, whether the enterprises carrying out such transactions are resident or non-resident.

- "Property" as including goods, articles or things and intangible property.

- "Services" as including financial services.

- "Transaction" as including number of closely linked transactions.

RULE 10B

Rule 10B provides for the manner in which the most appropriate method will be applied to determine arm's length price.

Section 92C provides for the following methods to determine arm's length price:

- Comparable Uncontrolled Price Method ("CUP")
- Resale Price Method ("RPM")
- Cost Plus Method ("CPM")
- Profit Split Method ("PSM")
- Transactional Net Margin Method ("TNMM")
- Any other method prescribed by the Central Board of Direct Taxes (CBDT)

While the assessee has a choice of following any of the methods, it has to be the most appropriate method having regard to the prescribed factors.

I) Comparable Uncontrolled Price Method ("CUP")

CUP is a method by which the price charged or paid for property transferred or services provided is compared with that of comparable uncontrolled transactions. The price of the uncontrolled transaction has to be adjusted to take into account differences with the International Transaction. The adjustment should take into account factors, which could materially affect the price in the open market. The adjusted price of the uncontrolled transaction would be regarded as the arm's length price applicable to the International Transaction.

II) Resale Price Method ("RPM")

Under the RPM, the price at which property purchased or services obtained by an enterprise from an Associated Enterprise is resold or is provided to an unrelated enterprise, is identified. The resale price is thereafter reduced by the normal gross profit margin and the expenses incurred by the reseller. The price so arrived at is required to be further adjusted to take into account the functional and other differences, which could affect the amount of gross profit margin in the open market. The adjusted price so arrived at is taken to be the arm's length price for the property / services.

III) Cost Plus Method ("CPM")

Under the CPM, the direct and indirect costs of production incurred by an enterprise in respect of property transferred or services provided to an Associated Enterprise, are ascertained. The amount of normal gross profit mark-up for provision of such property / services in a comparable uncontrolled transaction, is determined. Such normal gross profit mark-up is adjusted to take into account the functional and other differences, which could materially affect the profit mark-up. The costs are thereafter increased by the adjusted profit mark-up, which are taken to be the arm's length price for the property / services.

IV) Profit Split Method ("PSM")

The PSM has been prescribed as being applicable mainly for transfer of unique intangibles or any inter-related multiple International Transactions, each arm of which cannot be separately evaluated. For applying this method, the combined net profit arising to the Associated Enterprises engaged in the transaction is determined. The relative contribution made by each of the Associated Enterprises is then evaluated taking into account the functions performed, assets employed and the risks assumed, to determine the value of such contribution had it been performed by an unrelated enterprise performing comparable functions in similar circumstances.

The combined net profits are thereafter split in proportion to the relative contribution by each enterprise and the profit so apportioned is taken into account to arrive at an arm's length price. The split will be as under:

- In the first place the split will be of the basic return appropriate for the type of transaction; and
- Thereafter the residual net profit is required to be split in the prescribed manner

V) Transactional Net Margin Method ("TNMM")

Under this method the net profit margin realised by an Associated Enterprise from an International Transaction is computed in relation to a particular factor such as costs incurred, sales, assets employed, etc. The net profit margin realised by the assessee or an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base and adjustments are made to the profit margin to take into account the differences between:

- The International Transaction and the uncontrolled transactions; or
- The enterprises entering into such transactions, which could materially affect the open market net profit margin.

The net profit margin realised by the Associated Enterprise is established in conformity with the net profit margin of the uncontrolled transaction.

No preference to any method

Unlike in the draft rules, the final rules do not provide for any preference of transaction based methods compared to the profit based methods. Also, the provision in the draft rules that if two methods are found to be most appropriate, the method which provides results consistent with a third method should be treated as the most appropriate method, has been deleted.

COMPARABILITY FACTORS

Rule 10B provides that in deciding whether an International Transaction is comparable to an uncontrolled transaction, various factors would be taken into account including:

- Characteristics of the property / services;
- Contractual terms;
- Functions performed, assets employed and risks assumed by the respective parties;

- The market conditions including geographical location, size of the market, regulatory framework, cost of labour and capital, etc.

An uncontrolled transaction would be regarded as comparable with an International Transaction if either there are no material differences between the two or reasonable accurate adjustments can be made to eliminate the material differences.

Finally, Rule 10B provides that in comparing an uncontrolled transaction with an International Transaction, the data should relate to the same financial year. Data pertaining to two earlier years can be considered if such data influences determination of transfer price.

RULE 10C

MOST APPROPRIATE METHOD

The most appropriate method is the one which is best suited to facts and circumstances of a transaction and which provides the most reliable measure of arm's length price.

In selecting the most appropriate method, the factors which need to be taken into account would be:

- Nature and class of the international transaction;
- Functions performed, assets employed and risks assumed by the Associated Enterprise entering into the transaction;
- Availability, coverage and reliability of data;
- Degree of comparability between the International Transaction and uncontrolled transaction and between contracting enterprises;
- Extent to which reliable and accurate adjustments can be made to make the uncontrolled transaction comparable with the international transaction; and
- Nature, extent and reliability of the assumptions that are required to be made in applying a method.

RULE 10D
Documentation

The legal framework for maintenance of information and documentation by a taxpayer is provided in Section 92D which lays down that every person who enters into an international transaction with an associated enterprise shall maintain prescribed information and documents. The various types of information to be maintained in respect of an international transaction, the associated enterprise and the transfer pricing method used are prescribed in Rule 10D of the Income tax Rules, as under:

1) A description of the ownership structure of the enterprise and details of shares or other ownership interest held therein by other enterprises;

2) A profile of the multinational group of which the taxpayer is a part and 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 made by the taxpayer and the ownership linkages among them;

3) A broad description of the business of the taxpayer and the industry in which it operates and the business of the associated enterprises;

4) The nature, terms and prices of international transaction 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;

5) A description of the functions performed, risks assumed and assets employed or to be employed by the taxpayer and by the associated enterprise involved in the international transaction;

6) A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the taxpayer for its business as a whole or separately for each division or product which may have a bearing on the international transaction entered into by the taxpayer;

7) A record of uncontrolled transactions taken into account for analysing their comparability with the international transaction entered into, including a record of the nature, terms sand conditions relating to any uncontrolled transaction with third parties which may be of relevant to the pricing of the internationals transactions;

8) A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

9) 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;

10) 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 transaction;

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

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

13) 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.

Rule 10D also prescribes that the above information is to be supported by authentic documents which may include the following:

a) Official publications, reports, studies and data bases of the government of the country of residence of the associated enterprise or of any other country;

b) Reports of market research studies carried out and technical publications of institutions of national or international repute;

c) Publications relating to prices including stock exchange and commodity market quotations;

d) Published accounts and financial statements relating to the business of the associated enterprises;

e) Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transaction similar to the international transactions;

f) Letters and other correspondence documenting terms negotiated between the taxpayer and associated enterprise;

g) Documents normally issued in connection with various transaction under the accounting practices followed.

It is noteworthy that the information and documentation requirements referred to above are linked to the burden of proof laid on the taxpayer to prove that the transfer price adopted is in accordance with the arm's length principle. One of the conditions to be fulfilled for discharging this burden by the taxpayer is maintenance of prescribed information and documents in respect of an international transaction entered into with a associated enterprise. A default in maintaining information and documents in accordance with the rules is one of the conditions which may trigger a transfer pricing audit under Section 92C(3). Any default in respect of the documentation requirement may also attract penalty of a sum equal to two percent of the value of the international transaction (Sec 271AA).

There is no reference in the provisions included either in the Income tax Act or the Income tax Rules about any requirement to submit the prescribed information and documents at the stage of initial compliance in the form of submission of report under section 92E. All that Section 92E requires is that the concerned taxpayer shall obtain a report from an Accountant in the prescribed form (Form 3CEB) and submit the report by the specified date. Form 3CEB contains a certificate from the Accountant that in his opinion proper information and documents as prescribed have been maintained by the taxpayer. It does not require their submission along with the report.

While there is no requirement for their submission along with the report, Rule 10D requires that the information and document maintained should be contemporaneous as far as possible and should exist latest by the specified date for filing the report under section 92E. Section 92D also provides that information and documentation may be requisitioned by the Assessing Officer or the Appellate Commissioner on a notice of thirty days which period may be extended by another period of 30 days.

Although the law has prescribed no monetary limit in respect of international transaction covered by the transfer pricing requirements, an exception is provided in para 2 of Rule 10D in respect of the information and document requirement in respect of transactions not exceeding INR 10 million. It is provided that the above requirement will not apply to such transactions. However the concerned taxpayer may be required to substantiate on the basis of available material that the income arising from the international transaction is computed in accordance with the arm's length rule.
The prescribed information and documents are required to be maintained for a period of eight years. Rule 10D absolves a taxpayer entering into a international transaction which continues to have effect over more than one year from maintaining separate set of documents for each year. However separate documents are required for each year if there is any significant change in the terms

and conditions of the international transaction which have a bearing on the transfer price.

There have been press reports suggesting that the CBDT will shortly come out with a Circular providing for:

- Permissible range within which the price transacted will not be disturbed;
- Position with regard to documentation in respect of transactions entered into from 1st April, 2001 till 31st August, 2001; and
- That the arm's length price worked out by an assessee will not be disturbed so long as prescribed documentation is maintained, the recommended methods have been followed and the database on which reliance has been placed by the assessee is not incorrect.

RULE 10E

ACCOUNTANT'S REPORT -

An Accountant's Report has to be obtained in Form 3CEB; wherein he is required to:

- Express an opinion on whether proper information and documents as are prescribed have been maintained by the assessee in respect of the International Transactions; and
- Certify whether particulars given in Annexure to Form 3CEB are true and correct.

The Annexure to Form 3CEB requires furnishing of particulars of International Transactions. It requires the assessee to list the Associated Enterprises with whom International Transactions have been entered into and to give a description of such transactions. It requires statement of account paid / received in respect of the International Transaction and the method used by the assessee to determine the arm's length price.

CONCLUSION

Transfer pricing is inherent in the way the global economy is structured with sourcing and consuming destinations being different, with numerous organizations operating in multiple countries and most importantly due to varying tax and other laws in different nations.

Also nations have to achieve a fine balance between loss of revenues in the form of outflow of tax and making their country an attractive investment destination by giving flexibility in Transfer Pricing. One can choose to go to extremes like Singapore would be doing especially when it is the low tax country. Given that countries are not integrated into a global system, each of them want increase in total inflow through tax or FDI and something like VAT is not expected to remove this non-competitive method of attracting investment, countries will need to enact legislations on their own.

Thus, achieving the mentioned balance, suiting their conditions and pattern of international transactions, according to the stage of economic development they are in, are some of the challenges companies are facing as they become a global economic community.

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