International Transaction in Transfer Pricing: Explained

Transfer Pricing in India: Trends and History

India has embraced Transfer Pricing in 2001. Indian regulations have been generally in line with OECD principles.

Indian TP regulations are known for detailed documentation requirements. Steep penalties up to 4% of the value of transaction are levied in case of non-compliance.

India has been reported to be the Second toughest Transfer pricing jurisdiction in the world by renowned magazine TP week. India is only behind Japan.

Marking the augmenting Indian Revenue Department's transfer pricing awareness, it has been reported that cumulative adjustments to the tune of INR 95,000 crores only until assessment year 2008-09. Since introduction of Transfer Pricing regulations in India in 2001, the Directorate of Transfer Pricing has made adjustments of approximately US $ 20 billion of which US $ 10 billion was made in the recent audit cycle itself. The most repetitive issues have been marketing intangibles, corporate guarantee and share transfer.

Indian Transfer pricing regulations got more teeth vide the Finance Act 2012 which introduced Domestic Transfer Pricing.

Key Sections in Transfer Pricing

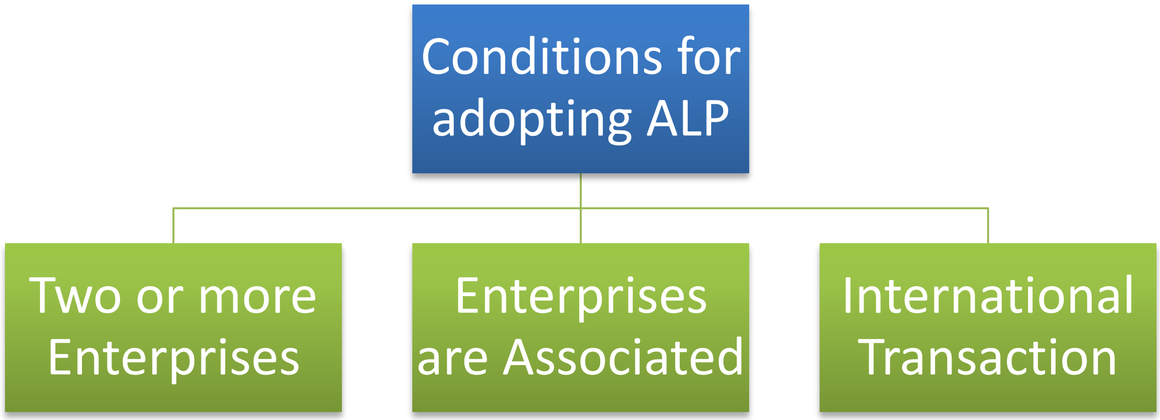
Transfer pricing in India is contained in a distinct Chapter X titled Special Provisions relating to Avoidance of Tax .It contains sections from 92 to 94A.

The Sections 92 to 92F exclusively dealing with Transfer pricing. They have been enacted with intent to lay down the statutory framework which proscribes the shifting of profits otherwise taxable in India to other countries using the veil of intra group transactions.

Section 92 is the pivotal section which lays down that

Any income from an *international transaction* shall be computed having regard to arm's length price.

Allowance for any expense or interest arising out of an international transaction also shall be computed having regard to arm's length price as clarified by the explanation.



What is Arm's Length Price?

Section 92F (ii) defines that

Arm's length price means a price applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.

The origin and meaning of Arm's length price is interesting.

PART I International Transaction

Section 92B (1) defines the Meaning of International Transaction:

a. Transaction between
b. two or more associated enterprises
c. either or both of whom are non-residents,

   In the nature of:

d. purchase, sale or lease of tangible or intangible property,
e. or provision of services,
f. or lending or borrowing money,
g. or any other transaction having a bearing on the profits, income, losses or assets of such enterprises,

   And includes:

   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

Deemed International Transaction 92B (2)

Any transaction between enterprise and other than associated enterprise shall be deemed as international transaction if:

- There is prior agreement between other person and enterprise
- Enterprise or associated enterprise or both of them are non-resident

Section 92B has been amended with retrospective effect from assessment year 2002-03. The explanation to Section 92 clarifies that international transaction includes:

a) the purchase, sale, transfer, lease or use of tangible property
b) the purchase, sale, transfer, lease or use of intangible property
c) capital financing
d) provision of services
e) a transaction of business restructuring or reorganization, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date

PART II Two/More Enterprises

"Enterprise" means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in

a) any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or
b) Any IPR of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights,
c) or the provision of services of any kind,
d) in carrying out any work in pursuance of a contract
e) in investment
f) provision of loan
g) 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

Transfer Pricing: Introduction

Rapid advances in technology, transportation and communication have given rise to a large number of multinational enterprises (MNEs) which have the flexibility to place their enterprises and activities anywhere in the world.

A significant volume of global trade nowadays consists of international transfers of goods and services, capital and intangibles (like IPR) within a MNE group. Such intra-group trade is growing steadily and arguably accounts for more than 30 percent of all international transactions.

It becomes important to establish the right price, called the "transfer price", for intra-group, cross-border transfer of goods, intangibles and services.

Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. It is the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, forming part of an MNE group.

Needless to say, transfer price may be arbitrary and dictated, with no relation to cost and added value, diverge from the market forces.

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 manufacture products in a 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.

The concept of treaty shopping and taking cover in tax havens has gained astronomical importance due to its capability to downscale tax incidence.

According to the Government Accountability Office, a five-story building called "Ugland House" in Cayman Islands is home to nearly twenty thousand(18,857) corporations. That's impressive, especially for such a small edifice. (Perhaps it has supernatural half-floors and space-time defying "mind tunnels")

Ugland House's distinction pales next to that of Corporate Trust Center, 1209 North Orange Street in Wilmington, Delaware. According to one investigation, the same address is home to 217,000 corporations.

PART III Associated Enterprises:

Meaning of Associated Enterprise Section 92A

Associated Enterprise is an enterprise which

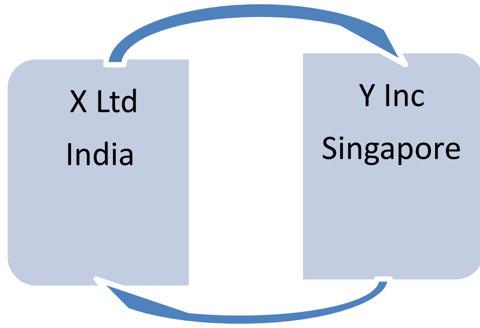
(a) which participates, directly or indirectly, or through one or more intermediaries, in the
    - management or
    - control or
    - capital of the other enterprise; or

(b) Similar persons participate in management, control or capital of an enterprise.

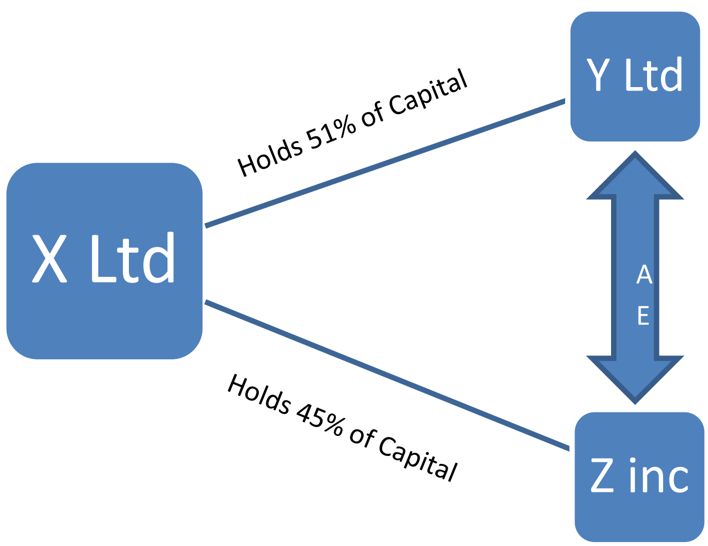
Two enterprises shall be deemed to be associated if during any time of the year:

(a) one enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in the other enterprise; or

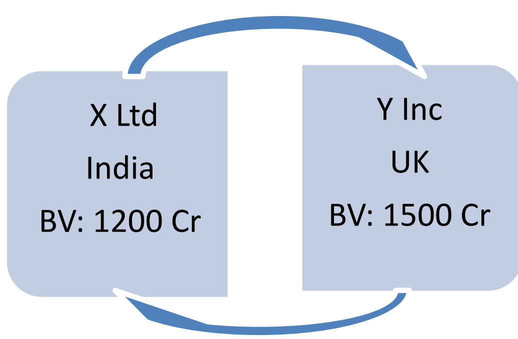
Holds 51% of Capital



(b) any person or enterprise holds, directly or indirectly, shares carrying not less than 26 % of the voting power in each of such enterprises; or



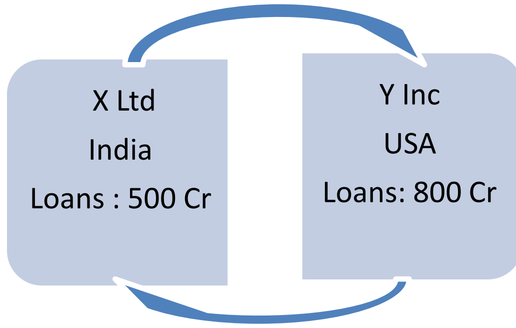
(c) a loan advanced by one enterprise to another constitutes not less than 51 % of the book value of the total assets of the other enterprise; or



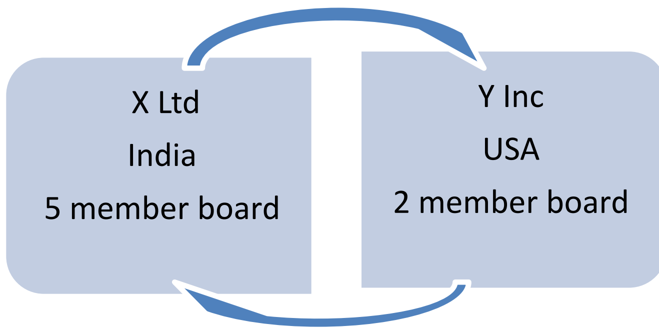
Advances Loan of 700 Cr

(d) one enterprise guarantees not less than 10 % of the total borrowings of the other;

Guarantees Loans of 95 Cr

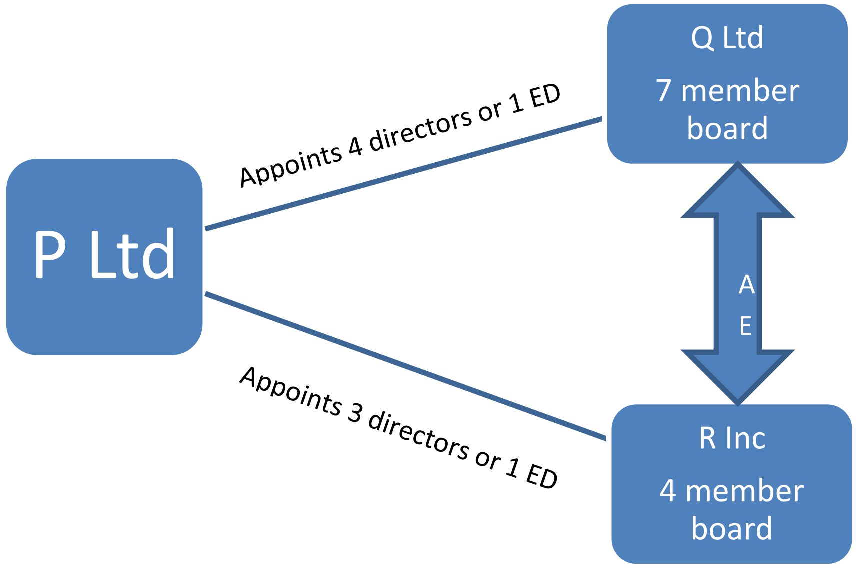


(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise;

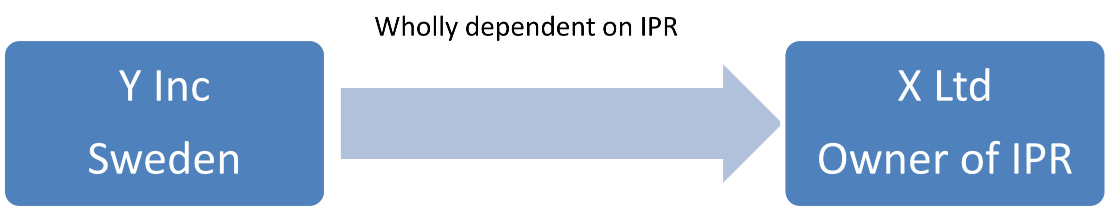


Appoints 4 Directors or 1 ED

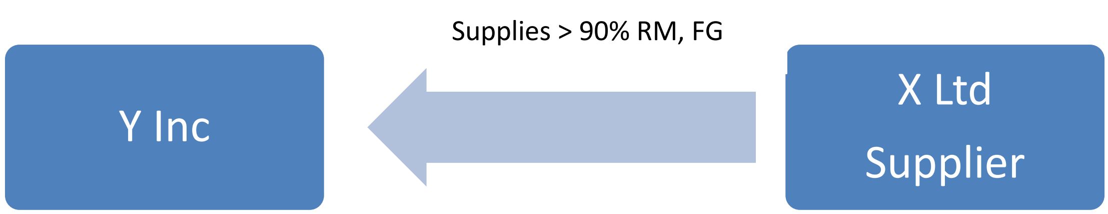
(f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons;

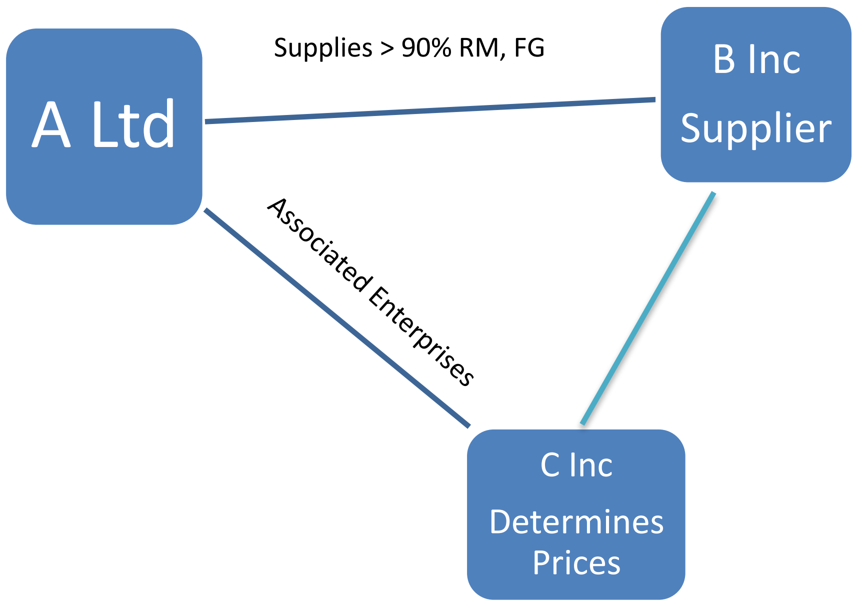


(g) the manufacture or processing of goods or articles or business carried out by one enterprise is *wholly dependent* on the use of any IPR, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights;

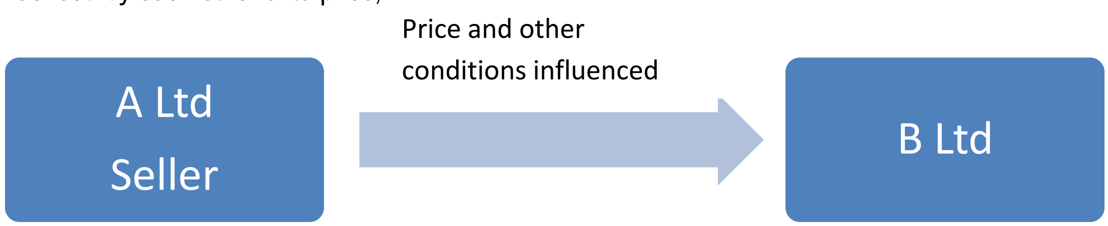


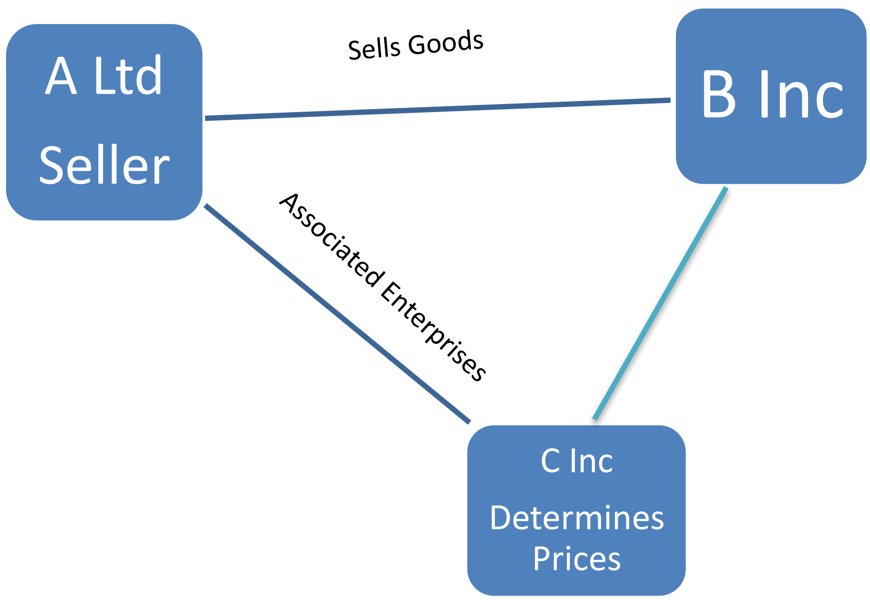
(h) 90% or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced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





(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;





(j) and (k)

One enterprise is controlled by	Another enterprise is controlled by
Individual	Individual or Relative or Jointly
HUF	HUF or member of HUF or jointly

(l) Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than 10 % interest in such firm, association of persons or body of individuals;

(m) Other prescribed relationship of mutual interest (Nothing prescribed)

Certain Special Issues & Tax Planning Provisions:

Raw Material:

90% of raw materials and consumables should be taken based on the value

Directly or Indirectly:

Only clauses (a) and (b) mention the words "directly or indirectly." Strictly construing the deeming provisions, clause (c) comprehends only a direct relationship.

Meaning of Book Value:

Section 92A (2) does not define the term book value. An increase in the revaluation of assets cannot be ignored here.

Appointment of directors:

The section only mentions about the actual appointment of director for the application of deeming provisions of associated enterprises. Holding the power to appoint directors, without actually appointing them will not attract these provisions.

Wholly dependent on another enterprise for intangible assets:

This provision clearly contemplates that WHOLLY dependent provisions shall only attract deeming provisions. Worded otherwise, partial dependency will not deem the enterprises as related.

Status of Continuing Debit balance:

A continuing debit balance per se, in the account of associated enterprises, does not amount to international taxation under Section 92B for which ALP computations can be made - Nimbus Communications Ltd Vs CIT 2011 (Mum)

Meaning of “Having regard to”:

Section 92 lays down that income from an international transaction should be computed “having regard to the ALP.”

The use of words “Having regard to” denotes that it is not incumbent on Assessing officer to compute ALP for each and every international transaction. Income of assesse need not necessarily be altered by substituting contracted value with ALP. Factors other than ALP like restrictions of government policy on free market play should also be given due consideration.

Intent to deceive revenue or mala fide motives not necessary:

Section 92 needs to be applied to all the cases of an international transaction where the price agreed is at variation with the arm’s length price. The presence of a negative intent is not required. Basing on the OECD guidelines, the need to adjust the pricing to approximate to an arm’s length standard arises irrespective of any contractual obligation undertaken or any intention of parties to minimize tax. It would never affect the underlying contractual obligations.

Conclusion

With businesses focused on erasing the physical borders, International business will be in vogue. Taxation cannot be an overriding factor in making investment decisions. A survey conducted by Ruding Committee revealed that almost half of multinationals in EU consider tax rates on business profits to determine the location. Being armed with adequate knowledge is the only way a prospective CA can deal daily with international taxation issues.