Thin Capitalisation and Arm's Length Pricing

A Sekar

B.Com., FCMA, ACS, LLB Gen
Practising Company Secretary, Mumbai

Sudha G Bhushan

B.Com., Hons, FCA, ACS
Practising Chartered Accountant,
Mumbai

Capital Structuring

The most important decision for financial planners in a company is with respect to the formulation of an ideal capital structure. The capital structure of any company consists of a mix of debt and equity. How much of the funds should be through equity and how much should be debt is a typical structuring decision.

Capital structure has to be determined not only at the time a company is promoted, but also later on as it requires funds from time to time.

The initial capital structure should be designed very carefully. The future structure will emerge out of the initial structure. The company will require funds to finance its activities continuously. Everytime the funds have to be procured, the pros and cons of various sources of finance have to be weighed and the most advantageous source of financing has to be selected each time. Thus the capital structure decision is a continuous ongoing decision and has to be taken whenever a company needs additional finance.

Generally, the factors to be considered whenever a capital structure decision is taken are :

(i) Leverage or Trading on equity
(ii) Cost of Funds
(iii) Cash flow
(iv) Control
(v) Flexibility
(vi) Size of the company
(vii) Sector to which the company belongs
(viii) Marketability including efficiency of financial markets
(ix) Tax considerations.

Capital structure is the composition of various sources of long-term finance in the total capitalisation of the company. These various sources of long term finance can be classified under two broad heads :

(a) Own Funds
(b) Borrowed Bunds.

Both own funds and borrowed funds including long-term loans from financial institutions are used by most of the large industrial companies. Capital structure planning—initially and on continuing basis—is of great importance to any company, as it has a considerable bearing on its profitability. A wrong initial decision in this respect may prove quite costly for the company. While deciding about capital structure, due attention should be paid to objectives like profitability, solvency and flexibility. The choice of the amount of debt and other fixed return securities on the one hand and variable income securities, namely equity shares on the other, is made after a comparison of the characteristics of each kind of securities and after careful consideration of internal and external factors related to the company's operations. In real life situations, compromises have to be made somewhere on the line between the expectations of companies seeking funds and the expectations of those that supply them. These compromises do not change the basic distinctions between debt and equity. Generally, the decision about financing is not of choosing between equity and debt but is of selecting the ideal combination of the two. The decision on debt-equity mix is affected by considerations of suitability, risk, income, control and timing. The extent of weightage that would be given to these factors will vary from company to company depending on the characteristics of the industry and the particular situation of the company. There cannot perhaps be an exact mathematical solution to the decision on capital structuring. Human judgement plays an important role in analysing the various aspects, before a decision on appropriate capital structure is reached.

High Gearing and Low Gearing

The term ''capital gearing'' or ''leverage'' normally refers to the proportion of relationship between equity share capital including reserves and surpluses to preference share capital and other fixed interest bearing funds or loans. In other words, it is the proportion between the fixed interest or dividend bearing funds and non fixed interest or dividend bearing funds. Equity share capital includes equity share capital and all reserves and surpluses items that belong to shareholders. Fixed interest bearing funds includes debentures, preference share capital and other long-term loans.

Capital Gearing can be defined as : ''The mixture of debt and equity in a firm's capital structure, which influences variations in shareholders profits in response to sales and EBIT variations.''

Formula of capital gearing ratio :

[Capital Gearing Ratio = Equity Share Capital / Fixed Interest Bearing Funds]

Capital gearing ratio is important to the company and the prospective investors. It must be carefully planned as it affects the company's capacity to maintain a uniform dividend policy during difficult trading periods. It reveals the suitability of a company's capitalization. But what it is suitable gearing in a particular case depends upon the facts and circumstances.

Apart from the financial and ''commercial'' considerations, the decision of capitalization is also greatly influenced by tax considerations. There may be situations when a company may not have access to debt based on its financial strength, but because of tax considerations may like to show and treat the finance received from its associated enterprises or related parties as its own debt to claim tax deductions. The tax authorities globally, however, have been quick to pounce upon such tax planning exercises. Different countries have made different rules to deal with such high gearing ratio. Over a period of time, the taxmen have been using the term ''Thin Capitalisation'' to refer to what finance professionals refer to as ''High Capital Gearing.''

While in strictly arms length transactions with institutional or commercial lenders, no problems are expected. What becomes relevant for financial planners and taxmen is the financing by promoters and their associated enterprises. The problem of capitalization however becomes relevant to the taxmen when securities are issued in the nature of debt, (which are in fact ''quasi equity'') and finance raised from ''promoters'' or ''associated enterprises'' for claiming interest deductions as tax benefits with the object of reducing the taxable income.

Thin Capitalization

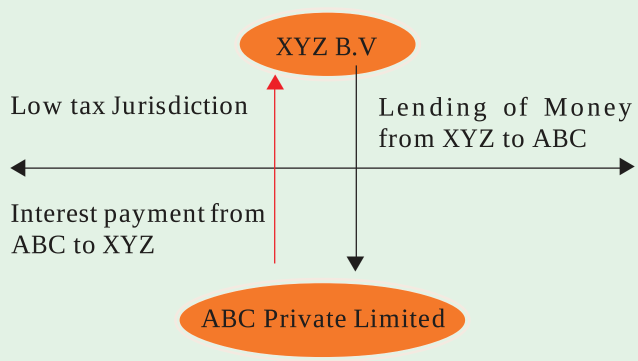
We are discussing the concept of Thin Capitalisation in the background of financing by way of ''quasi equity'' by promoters or associated enterprises and the taxmen's response to this practice.

A company is said to be thinly capitalized when its capital is made up of a much greater proportion of debt than equity, ie. its gearing or leverage, is too high. This is perceived to create problems for two classes of people :

- consumers and creditors bear the solvency risk of the company, which has to repay the bulk of its capital with interest; and
- revenue authorities, who are concerned about abuse by excessive interest deductions.

An entity (which may be part of a group) may be said to be thinly capitalized when it has excessive debt in relation to its arm's length borrowing capacity, leading to the possibility of excessive interest deductions. An important parallel consideration is whether the rate of interest is one which would have been obtained at arm's length rate while comparing from independent lender as a stand-alone entity.

In international transactions, the typical method of tax avoidance employed is the use of a thinly capitalized subsidiary that borrows from the parent or an off-shore vehicle, with the lender being in a low tax jurisdiction.



The main purpose of such an exercise is to shift profits from the country where profits are made to a tax haven. Many countries have introduced withholding taxes on interest payments made by the thinly capitalized company to counter this shifting of profits. Thin capitalization rules usually go beyond just the levels of debt and equity.

Thin Capitalization rules can apply in situations where :

- A security is issued, which would not have been issued without a special relationship between the parties (tax deductions for interest on loans from group entities are stopped where the borrower would not have been able to sustain the debit on its own).
- A loan is made because of a guarantee given to the lender by a party related to the borrower.

The expression 'thin capitalisation' is commonly used to describe a situation where the proportion of debt to equity exceeds certain limits. Thin capitalisation legislation is a tool used by tax authorities to prevent the apparent leakage of tax revenues as a consequence of the way in which a company is financed. Financing a resident company with debt is considerably more tax efficient than financing with equity. The difference in tax treatment is an incentive to provide capital to the company in the form of debt instead of equity. If there are no thin capitalisation rules, it is relatively easy for a non-resident to advance funds to a resident company in a way that is christened as debt, so that the ''interest payments'' are straightaway tax deductible. If controlling shareholders in particular are indifferent to the form in which their investment is structured are more likely to be guided by tax considerations when structuring the legal form of their investment.

The object of Thin Capitalisation Regulations is to prevent the use of excessive 'captive' or 'in-house' or 'friendly' loans which would be detrimental to the revenue of home country (where the borrower is resident), as the profits to this extent would effectively be shifted to the foreign lender, as the interest payments would be tax deductible in the home country.

Therefore many countries—through Thin Capitalisation Regulations—ensure that the deductions for interest on debt owed to connected parties, is allowable in the home country as a deduction in the hands of the borrower, only if within the permissible limits. While financial leverage has, on its own standing, its own value, this is definitely impaired when interest is not deductible either wholly or partially through these Thin Capitalisation Regulations.

Brief Comparative analysis of Thin Capitalisation Rules by different jurisdictions

A wide variety of methods are used to deal with thin capitalisation in various countries. These approaches range from complex legislation to no specific thin capitalisation legislation at all.

Within this range four general approaches may be distinguished :

(1) the fixed ratio approach
(2) the subjective approach
(3) application of rules concerning hidden profit distributions; and
(4) the 'no rules' approach.

The emphasis on the above factors or combinations of factors often varies from country to country. Measures taken by countries to limit excessive debt financing by shareholders are either based on specific legislation or administrative rules or based on evolving practice.

Under the 'fixed ratio' approach, if the debtor company's total debt exceeds a certain proportion of its equity capital, the interest on the loan or the interest on the excess of the loan over the approved proportion is automatically disallowed and/or treated as a dividend. The ratio may be used as a safe-haven rule. It can be seen that these countries which use the fixed ratio approach usually have specific thin capitalisation legislation.

The basis of the 'subjective' approach is to look at the terms and nature of the contribution and the circumstances in which the financing has been made and to decide, in the light of all facts and circumstances, whether the real nature of the contribution is debt or equity. Some countries using the subjective approach have specific legislation. Other countries use more general rules if these are available, such as general anti-avoidance legislation, provisions on 'abuse of law', provisions on substance over form.

There are also countries that apply 'hidden profit distribution' rules to reclassify interest as dividends. In some of these countries the hidden profit distribution rules are applied along with specific rules which limit the deduction of interest on loans from shareholders. The general principles of transfer pricing rules may also play a role in this respect.The underlying idea is that if the loan exceeds what would have been lent in an arm's-length situation, the lender must be considered to have an interest in the profitability of the enterprise and the loan, or any amount in excess of the arm's-length amount, must be seen as being designed to procure share in the profits.

While some countries, like France, have detailed regulations, others, like the UK, do not specify a debt to equity ratio, but merely give the right to the Inland Revenue to challenge the interest deductions keeping in view the arm's-length principle.

In the following paragraph, a brief overview of the approach to Thin Capitailsation Rules in countries which provide for safe harbor provisions are given :

Country	Limitation	Comments
Australia	Debt : Equity 3 : 1	In 2002, Australia's thin capitalisation regime changed substantially, bringing in lengthy and complex legislation. A 'safe harbour' debt amount has been introduced, with an alternative ''arm's length'' test which can potentially increase the permissible interest Exceptions made for certain financial businesses—authorised deposit takers Interest in excess of the prescribed level is denied as a deduction. However, it is fully deductible if the company satisfies the arm's length test. The Australian Tax Office has a well-organised and accessible website, with good search facilities.

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Country	Limitation	Comments
Germany	Limit to deductibility of interest (30% of income)	The legislation was substantially revised in 2008 Interest deductibility is limited to 30% of taxable income before interest, taxes on income, depreciation and amortisation. There are exceptions for low interest expense, and where interest paid to any one shareholder falls within limits. Previously Germany had a widely available safe harbour: a debt:equity ratio of 1.5 : 1
France	Interest limitation by ref to third party rates Arm's length measure for interest rate Debt : equity 1.5 :1 25% interest : operating income ratio	A new system was applied from January 2007, applying limitations between related parties, and bringing in the arm's length measure. Interest rate limitations : deduction limited to an average of rates charged by lending institutions, or the interest rate that the debtor company could have obtained from a third-party lender and Debt-based limitations : overall indebtedness (debt : equity ratio), and Disallowed interest can be carried forward indefinitely at group level, but will be reduced annually by 5% from the second year after the expense was incurred. There is no differentiation between types of companies. Companies are considered on a stand alone basis. Certain financial businesses and transactions are excluded.
Japan	3 : 1	• Japanese thin capitalisation rules were revised in 2006. • A debt:equity safe harbour rule applies to foreign-owned corporations • The 2006 rules extend this to third parties where foreign corporations guarantee the borrowing
China	Financial 5 : 1 Non-Financial 2 :1	China introduced thin capitalisation legislation for the first time late in 2008. Two safe harbour ratios have been set, one for financial industry enterprises, one for non-financial. If these ratios are breached, it appears that the taxpayer will still have the opportunity to try to demonstrate that the transaction is still consistent with the arm's length principle.

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Country	Limitation	Comments
USA	1.5 : 1	The US "earnings stripping rules" currently include a restriction on interest paid by a corporation to related persons, if the corporation has : A debt-to-equity ratio exceeding 1.5 : 1, and A net interest expense exceeding 50% of the company's adjusted taxable income. This is likely to be tightened, probably to 25%

India and Thin Capitalisation

As of now India does not have any specific Thin Capitalisation Rules. In one of the leading case on the subject, in absence of "thin capitalization rules", interest paid to shareholders for loans cannot be disallowed despite capital-structure tax-planning resorted by the tax payer. This was the decision by the Income Tax Appellate Tribunal (ITAT) in the case of Besix kher Dabhol SA v DDIT.

The assessee, a Belgium company, was set up to execute a project in India and had a PE in India. The assessee's share capital of Rs. 38 lakhs was owned by two foreign companies (shareholders) in the ratio of 60 : 40. The said two shareholders also advanced loans to the assessee aggregating Rs. 94.10 crores in the same ratio in which they held shares in the assessee i.e. 60 : 40. The assessee's debt-equity ratio was 248 : 1. The assessee paid interest of Rs. 5.73 crores on the loans obtained from its shareholders and claimed that as a deduction. The AO disallowed the claim on the ground that though the moneys were borrowed from the shareholders, in view of the abnormal debt-equity ratio, they were to be treated as capital / loan taken from the Head Office, and (ii) that as the RBI approval did not permit the PE to borrow, the loan was in contravention of law. This was upheld by the CIT (A). On appeal by the assessee, HELD allowed the appeal :

(i) Under Article 7 (1) & 7(3)(b) of the India-Belgium DTAA, the profits of the assessee as are attributable to the PE are chargeable to tax in India. In determining such profits, all expenses are allowable subject to limitations specified in the DTAA and the Indian laws. The only limitation is that notional interest paid by a branch to its HO is not allowable.This limitation does not apply as the assessee borrowed from an outside party, i.e. its shareholders;

(ii) The argument of the revenue that the abnormal debt-equity ratio attracts the "Thin Capitalization Rule" and that the "debt" should be characterized as "equity" for purposes of considering whether interest is deductible is not acceptable. Several countries have detailed "thin capitalization rules" (e.g. Belgium). However, there are no such rules in India though the

DTC 2010 has proposed this vide S. 123(1)(f). In the absence of specific ''thin capitalization'' rules, it is not open to the revenue to characterize debt as equity and disallow the interest (principles in Azadi Bachao Andolan 263 ITR 706 (SC) followed). The domestic law limitation of Art. 7(3) refers to the Source Country & not the Residence Country;

(iii) Imposing the ''thin capitalization rules'' on the assessee when domestic companies are not subject to such rules will violate the ''non-discrimination'' provision in Art. 24(5);

(iv) The argument that the finance structure should be treated as a ''colourable device'' and disregarded is not acceptable because there is no anti-abuse provision in the DTAA and in the absence of specific language (such as the proposed s. 129(9) of DTC 2010), the DTAA cannot be over-ridden by the Act.

Master Circular issued by RBI under Foreign Exchange Management Act, 1999 (FEMA) and Regulations

It would be of interest to note that the latest RBI Master Circular on External Commercial Borrowings (ECB) stipulates a debt equity ratio of 4 : 1 for borrowings by Indian Entity from ''Recognized Lenders'' in excess of US $ 5 Million from ''Foreign Equity Holders''. The Foreign Equity Holders should hold a minimum of 25% of the Equity of the eligible borrower. Further the regulations clarify ''ie. borrowing the proposed ECB not exceeding four times the direct foreign equity holding''. This adds a new dimension to the basic question of Debt Equity ratio.

General Anti-Avoidance Provisions (GAAR)

Though the Union Budget 2012-13 proposals do not contain any direct ''Thin Capitalisation Rules'', certain new provisions entitled ''General Anti-Avoidance Rules'' have been proposed, which, if implemented, can give rise to new dimensions to the issue of Thin Capitalisation concept.

The scope and language of the proposed GAAR provisions under the Union Budget 2012 are very similar to the GAAR provisions specified in the Direct Tax Code (DTC). It is proposed to empower the tax authorities with widespread powers to disregard and recast any tax avoiding transaction and income accruing therefrom. Further, the Finance Bill 2012 proposes the introduction of sub-section 2A to Section 90 which would enable the provisions of GAAR (proposed to be introduced through Chapter X-A in the Income-tax Act, 1961) to override the provisions of the tax treaties signed by India. While the revenue authorities may be viewing GAAR as a means to checking tax leakages, one may be tempted to suspect the intention of the sweeping nature of the provision as it provides wide discretion to the tax authorities and provides potential for misuse.

GAAR vs. Treaty provisions

It has been proposed that the GAAR provisions would apply to a taxpayer irrespective of the fact that the treaty provisions are more beneficial. It may be noted that a unilateral enactment of a new domestic tax law which is contrary to an existing treaty, without an amendment in treaty could possibly be regarded as violation of international law and is generally known as 'treaty override'.

It may be relevant to note that according to rules of legislative interpretation, specific legislation overrides general legislation. Therefore, an argument may be taken that change of a domestic law generally, which could be the case with GAAR, may not affect the treaty. However, in the absence of an anti-avoidance provision under the treaty, the reaction of India's treaty partner countries needs to be observed.

Salient features/provisions of GAAR

The Indian tax law has always had specific anti-avoidance rules to target known arrangements of tax avoidance, whereas GAAR seeks to completely redefine this concept. GAAR as envisaged under the Finance Bill 2012 is a broad set of provisions which seek to tax an 'impermissible avoidance arrangement' (which may be a step, a part or whole of an arrangement and hereinafter referred to as 'Transaction') whose main purpose is to obtain a tax benefit by :

a. creating rights or obligation which wouldn't arise between persons dealing at arm's length, or
b. result in the misuse or abuse of the provisions of the Act in any way, or
c. lacks commercial substance either wholly or in part, or
d. entered or carried out in a manner which would not be employed for bona fide purposes

While the principal condition for invalidating a transaction might be triggered at the assessment stage itself, the burden to rebut the same shall rest with the tax payer. Further, once the 'tax benefit' test is satisfied, the arrangement also has to satisfy at least one out of four additional tests discussed above.

The tax authorities, upon satisfaction of aforesaid conditions, shall seek to :

a. disregard, combine or recharacterise any step, part or whole of a transaction;
b. treat the transaction as if it had not been entered into;
c. disregard any accommodating party or treating any accommodating party and any other party as one and the same person;
d. deeming connected persons in relation to each other as one;
e. reallocating, amongst the parties to the arrangement —
   - any accrual, or receipt, of a capital or revenue nature; or

- any expenditure, deduction, relief or rebate; or

f. relocating place of residence of a party or location of a transaction or situs of an asset to a place other than provided in the arrangement; and

g. considering or looking through an arrangement by disregarding any corporate structure.

For the above purposes, following re-characterization may be done —

- any equity into debt, or vice versa;
- any accrual, or receipt, of a capital or revenue nature; or
- any expenditure, deduction, relief or rebate.

Meaning of some of the terms used in GAAR

1. Accommodating Party

Accommodating party means a party to an arrangement whose main purpose for direct or indirect participation in an arrangement (in whole or in part) is to secure benefits whether directly or indirectly to a person to whom it may be connected or not.

2. "An arrangement" means

- any step in or a part or whole of
- any transaction, operation, scheme, agreement or understanding,
- whether enforceable or not, and
- includes any of the above involving the alienation of property.

3. "Tax benefit" means

- a reduction, avoidance or deferral of, or an increase in a refund of tax under the Income Tax Act ("ITA" or "the Act").
- a reduction, avoidance or deferral of, or an increase in a refund of tax for a Tax Treaty.
- a reduction in tax bases including increase in loss.

4. "Arm's length price" means

- a price applied or proposed to be applied in a transaction between persons or enterprises other than associated enterprises in uncontrolled, unrelated or independent conditions.

5. "Associated Enterprises" means as defined in Section 92A of the Act.

6. "Lacks commercial substance"

A step in, or a part or whole of, an arrangement shall be deemed to be lacking commercial substance, if —

- The substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

- it includes, or involves —

i. round trip financing without regard to, —

(a) whether or not the round tripped amounts can be traced to funds transferred or received;

(b) the time, or sequence, in which round tripped amounts are transferred or received; or

(c) the means by, or manner in, which round tripped amounts are transferred or received;

ii. an accommodating or tax indifferent party;

iii. any elements that have the effect of offsetting each other; or

iv. a transaction which is conducted through one or more persons and disguises the nature, location, source, ownership, or control, of the fund.

7. "Round trip financing" includes financing in which —

Funds are transferred among the parties to the arrangement in a manner which would :

- result, directly or indirectly, in a tax benefit; or
- significantly reduce, offset or eliminate any business risk incurred by any party to the arrangement.

Some Concerns about GAAR and recommendations to overcome them

The description and definition as proposed renders GAAR subjective and open to interpretation. Perhaps, introduction of guiding principles should be evolved so as to make the same objective, more definite, fair, equitable, meaningful and relevant.

Specifically if one were to refer to the explanation / meaning of "lacking of commercial substance", this one phrase can typically lead to a series of litigations. With the shifting of the onus of proof to the taxpayer, it has to be only hoped that the final outcome of the interpretation does not result in 'Commercial Nonsense'

Though the provisions relating to GAAR are broadly in line with the internationally accepted standards of anti-avoidance measures, it may be noted that some of the important recommendations of the Standard Committee on Finance have not been taken into account while introducing the GAAR provisions, such as :

- Suitable provisions may be made to protect the interest of the tax-payers who have entered into structures / arrangements under the existing law in good faith and without intent to evade tax;

- Uncertainties with regard to applicability of tax treaty provisions to be removed so that India's credibility as a reliable treaty partner is not affected;

- The proposals should not lead to any fiscal uncertainty or ambiguity;

- It should be ensured that any of the proposals do not pave the way for increased and avoidable litigation.

With respect to thin capitalization, an entirely new concept of re-characterization of debt into equity or vice versa. The emphasis is on the term "vice versa" which means that debt can also be classified into equity. Such reclassification including the circumstances in which this could result will be a completely new concept to which this complex financial world may not have a ready answer.

Applicability of Thin Capitalisation Norms for domestic companies

The budget proposals have introduced a new section by which specified domestic transactions have been brought under the purview of Transfer Pricing regulations. The computation of value of Specified Domestic Transactions should, therefore, be as per Arm's Length provisions under Transfer Pricing regulations. The provision would be applicable if the value of Specified Domestic transactions in aggregate exceeds 5 Crores.

The Specific Domestic Transactions for the purposes of application of Transfer Pricing provisions would be :

(a) Expenses / payment transactions between related persons as covered under the provisions of Section 40 A (2) (b);

(b) Transfer of goods / services / business from one unit / undertaking of the Assessee to another unit / undertaking of the assessee, claiming benefit under Section 80 IA, under Chapter VI A or 10 AA where the provisions of 80IA are applicable;

The assessees in such cases would be required to maintain / furnish documentation and obtain certification of Specified Domestic Transactions.

The other Transfer Pricing provisions pertaining to international transactions would also be applicable for Specified Domestic Transactions.

Section 40A (2)(b) would even cover transactions of interest payments to related parties and consequently the provisions contained in the other transfer pricing regulations including the GAAR and the thin capitalization rules / test could apply to quasi-equity financing by related parties christened as debt. This is going to be a new challenge for domestic companies, most of whom are not even exposed to the concept of Thin Capitalisation and the prevalent rules.

Challenge before Indian Companies

Indian companies having international transactions are exposed to international financing pattern and the global taxation trends. For these companies, the concept of thin capitalization is going to add a new variable to the financial and tax structuring.

The greater challenge is, however, going to be faced by pure domestic companies in the SME sector, where there is a reasonable amount of related party transactions much beyond the stipulated the threshold levels of Rs. 5 crores which appears to be fairly low.

When there are many SME companies / organizations in a group, a great deal of planning would have to be done to plan and implement the capital structure in such a way that the group goals are achieved without falling into the erring side of the tax net.

Quite a few companies in the SME sector are known to be facing finance problems and are struggling to obtain debt financing at competitive rates. In such cases, it is usual for the companies to arrange finance from related parties (including group companies) in the form of unsecured loans carrying structured interest rates rather than equity to meet the promoter's contribution requirements for obtaining maximum possible bank finance. The lending banks treat this ''structured debt'' as ''Quasi-Equity'' and fit it as ''Equity'' in their assessment for ''Debt-Equity Ratio''. If this structure is viewed by the tax authorities under the lens of GAAR and read with the proposed domestic transfer pricing regulations and the interest charged is below the bank rate, the tax authorities can, under this situation, impose tax on the differential interest or even treat this ''structured debt'' as equity, and disallow the interest deduction claimed by the borrowing company. All these could lead to uncertainties and unpredictable litigations.

There will be widespread ambiguity on what is the ideal or safe debt-equity ratio which would be acceptable to the tax authorities. We have seen the confusion created by the RBI Master circular while stipulating the debt-equity ratio with respect to ECB from foreign equity holders. When we have multiple regulators giving different interpretations and meanings to otherwise established definitions, the problem becomes more complex. Further complicating this would be the GAAR driven as it would be by revenue collecting considerations, the emerging confusion is going to be more and more difficult to comprehend—particularly to the domestic SME sector which is in dire need of greater flexibility and openness.

There will be a great role for Management Accountants and other financial consultants in evolving a proper group structure and also capital structure for individual entities, apprising them of the regulations and consequences of default simultaneously so that there emerges

(a) good commercial sense not only at the group level, but also at the entity level; and

(b) there is better understanding on the part of these groups and entities of the complex level of challenges to be faced in balancing commercial, regulatory and tax considerations; and

(c) the potential for commercial nonsense—which disastrous short term opportunistic planning will anyway entail—is reduced. ❐

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Arm’s Length Pricing in India

Dr. Sukamal Datta

Principal
Naba Ballygunge Mahavidyalaya (C.U.)
Kolkata

Introduction

The Arm’s Length Principle is the condition that both the parties to a transaction are independent and are on equal footing. This type of transaction is known as an ‘Arm’s Length Transaction’. It is generally use in contract law for the arrangement of an equitable agreement though either the parties may have shared interests or they are closely related to each other to be seen as completely independent. In the present global business environment it is observed that large multinational companies have subsidiary companies and those companies conduct business transactions with one another as if they are not at all part of the same corporate family. When two companies, any way, are connected with each other, the type of business they transact is often referred to as an ‘arm’s length transaction’. It is a deal between two interested associates parties. They show the behaviour as if they were not related, so that there is no query of a disagreement of attention. The concept of arm's length deal concerns with the transaction in which both the parties behave in their self-attention and are not issue any force from the other associate. The basic principle behind the arm’s length price is that though the both the buyer and seller are related to a parent concern, the prices extended will still remain at fair market value. This means that the seller company will offer no special in-house discount to the buyer company though both of them are subsidiaries of a parent company i.e. the subsidiary company will enjoy the same volume of discount that may be extended to any customer with a similar pattern of volume purchasing. So, the arm's length price is the price in which a sister company never expects any discount or reduced price that would be extended to other customers. The comparability between the controlled and uncontrolled transaction is the key factor for determining the arm's length price an international transaction.

Arm’s length price essentially conducts two things at a time : (i) this form of pricing structure protects the financial position of the seller company; and (ii) helps to prevent the question of taxes arising from such transaction. Many countries including India have their laws for determining inter-company or arm's length price structures. With the extension of arm's length price, there is no question about conflict of interest of buyer and seller. Here the revenue is completely transparent and there is no hidden motive in the transaction. According to the internationally accepted principles, any income from international transaction or an outgoing—like expenses or interest from the international transaction between associated companies—shall be computed extending an arm’s-length price that would be charged in the transaction if it had been entered into by unrelated parties in similar conditions. Some companies occasionally try to manipulate inter-company prices to reduce overall tax burden. On the other hand, tax authorities want to ensure that the inter-company price is equivalent to an arm's length price to prevent the loss of tax revenue.

Computation of Arm’s length Price u/s 92C of Income Tax Act

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 :

(a) Comparable Uncontrolled Price Method,
(b) Resale Price Method,
(c) Cost Plus Method,
(d) Profit Split Method,
(e) Transactional Net Margin Method, and
(f) Such other Method as may be prescribed by the Board.

From the above six methods the most appropriate method shall be applied for determination of arm’s length price provided that, where more than one price is determined as the most appropriate method, the arm’s-length price shall be taken to be the arithmetic mean of such prices or at the option of the assessee, a price which may vary form such arithmetic mean not exceeding five per cent. To make it clear we may