Concepts of Transfer Pricing

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BACKGROUND:
The existence of different tax rates and rules in different countries offers a potential incentive to multinational enterprises to manipulate their transfer prices to recognize lower profit in countries with higher tax rates and vice versa.
EG: The existing tax rates in India are at a basic of 30% (ignoring surcharge, EC and SHEC); and tax rates in Mauritius for a business enterprise of 'GBC 2(International)' category is 3% basic. An MNC carrying on trade both in India and Mauritius may show Nil or negligible profits accruing in India and almost the entire profit shown to be accrued in Mauritius. This helps a Company pay minimal tax at the base rate of a mere 3%, causing damage to taxation revenues earned by the home country (India, in this case). It may also lead to what is called '**Tax rate reduction Wars'** between various countries, wherein they constantly decrease their tax rates, in order to cause the business/ corporate house to show maximum profits in their country, thus enhancing their taxation revenues. Hitherto there was no provision in the Income Tax Act to curb this problem.

THE MEANING:

- Transfer Pricing is the fixation of the price of a product / service between two associated parties which falls within the definition of OECD guidelines. If Transfer Price is not fixed on an Arm's length transaction, then one country's tax revenue would be affected.

- Transfer pricing is a very important issue relating to Taxation for all the Companies, which have multinational presence.

  - In the near future, probably, this could be one of the important taxation issues that would attract the board level attention.

  - Transfer Pricing though primarily related to taxation, has a level of relevance to strategic decision making as it is also considered as a tool to maximize operating performance.

APPLICABILITY:

- Two or more enterprises engaged in specified activity, where one enterprise is the owner of the other or has exclusive rights.

- Associated or Deemed to be associated enterprises entering into international transactions.

CURRENTLY APPLICABLE PROVISIONS:

With a view to provide a detailed statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, the Finance Act, 2001 substituted section 92 with a new section and introduced new sections 92A to 92F in the Income-tax Act, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of information and documents by persons entering into international transactions and definitions of certain expressions occurring in the said section.

Section 92: As substituted by the Finance Act, 2002 provides that any income arising from an international transaction or where the international transaction comprise of only an outgoing, the allowance for such expenses or interest arising from the international transaction shall be determined having regard to the arm's length price. The provisions, however, would not be applicable in a case where the application of arm's length price results in decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

Arm's length price: In accordance with internationally accepted principles, it has been provided that any income arising from an international transaction or an outgoing like expenses or interest from the international transaction between associated enterprises shall be computed having regard to the arm's length price, which is the price that would be charged in the transaction if it had been entered into by unrelated parties in similar conditions. The arm's length price shall be determined by one of the methods specified in Section 92C in the manner prescribed in Rules 10A to 10C that have been notified vide S.O. 808 E dated 21.8.2001. **Thus, a price at which independent enterprises deal with each other should be reckoned as the Arm's Length Price.**

RESPONSIBILITY OF THE ENTERPRISE:

Section 92D provides that every person who has been a party to an international transaction, during a previous year, shall keep and maintain such information and documents, prescribed by the Board, as will assist the Assessing Officer to compute the income arising from that transaction, having regard to the arm's length price.

The requirement to keep and maintain such information and documents with respect to an international transaction has, however, been waived in the case of those persons who have entered into international transactions the aggregate value of which, as recorded in the books of account, does not exceed **one crore rupees- rule 10D(2)**.

Assessee must maintain the information and records for a period of **eight years** from the end of the relevant assessment year- Rule 10D (5).

Arm's Length Price - Methods

- Comparable Uncontrolled Price (CUP)
- Resale Price (RP)
- Cost Plus (CP)
- Profit Split (PS)
- Transactional Net Margin (TNM)
- Such other methods as may be prescribed

I. Comparable Uncontrolled Price (CUP)

- Price charged or paid in an Comparable Uncontrolled Transaction is identified

- Such Price is adjusted to account for differences, if any, between the International Transaction and the Uncontrolled Transaction which could materially affect the price in open market, and

- The price so adjusted is taken to be Arm's length price in relation to the International Transaction

  Case Study

- "X", a company in US, sells softwares of Accounting Programs to Indian Subsidiary - "Y" for resale @ USD 3.5 million. "X" also sells the same product to other resellers (say "Z") in India with identical terms. If "X" sells to "Z" the same software for USD 4 million, then the CUP price for sales by "X" to "Y" would also be USD 4 million, 0.5 million charged less to "Y" by "X".

- **Impact in X & Co. Books:**
  a. Profit up by USD 0.5 Million
  b. Taxes up proportionately

II. Resale Price

- The price at which goods, articles or things purchased from the associated enterprise are resold to unrelated enterprise is identified.

- Such resale price is reduced by reasonable expenses incurred by the enterprise or by an unrelated enterprise in a Comparable Uncontrolled Transaction

- The price so arrived is further reduced by the amount of normal profit margin in the Comparable Uncontrolled Transaction

- The price so arrived is adjusted against the differences, if any, in the transaction being compared, which could materially affect such expenses or profit margin in the open market.

  Thus price arrived to be taken in the Arm's Length Price of the enterprise from the associated enterprise

  Case Study
- "Y", an associate enterprise, is a distributor for the products developed by its parent company "X" which is in US.

- The retail price of the product is Rs.20,000/-

- An independent distributor in India, who is comparable to "Y" gets 20% margin.

- Then the Arm Length Price would be

Retail Price in India	Rs.20,000
Less: Margins of comparable Distributors (20%)	Rs. 4,000

TP using Resale Price Method	Rs.16,000
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III. Cost Plus

- This method is used for contracts for manufacture / Service which bear little risk

- The captive activity and the related cost is to be identified

- The normal margin in a Comparable Uncontrolled Transaction is to be identified

- Then the margin is to be adjusted for material differences

- Such adjusted price could be treated as the Arm's Length Price.

- The costs incurred by the supplier of the property in a controlled transaction is identified.

- Appropriate cost plus mark up is added to the cost to arrive at appropriate profit for the functions performed (Considering the market condition, risks involved, assets used, etc.,)

- This is regarded as Arm Length Price or original controlled transaction.

  Case Study
- "Y" Indian Company is a wholly owned Subsidiary of "X" in US who manufactures luxury cars.

- "Y" has an assembly plant and does not supply capital items / automotive knowledge / take any risk.

- Comparable Company to "Y" in India, based on the analysis of financial statements, earns 35% on costs

- "Y" is being charged at Rs.1,00,000/- per car by "X"

- Applying the above margin of 35%, the Transfer Price under this method work out to Rs.1,35,000/-.

IV. Profit Split Method

- This method is used in cases where multiple transaction amongst Associated Enterprises which are so interrelated and they cannot be evaluated separately for the purpose of determining the Arm's Length Price of any one Transaction by which

  - The combined profits of all associated enterprises from all such transactions are determined

  - The relative contribution of such profits are evaluated on the basis of functions performed by unrelated enterprises performing functions.

- The combined profits are then split amongst the enterprises in proportion to their relative contribution.

- The profits thus apportioned to arrive at Arm's Length Price in relation to International Transaction.

  Case Study
- "X" an intangible holding company in US provides Patents and Copyrights to a related manufacturing company in India - "Y".

- "Y" sells entire production to a related marketing company "Z"

- Methodology to be followed to determine the Arm Length Price for royalty to be paid by "Y" to "X" for patents and copyrights provided are :

- Companies comparable to "Y" are to be found

- Based on the profits of those companies, optimum profit of "Y" to be determined.

- Companies Comparable to "Z" are to be found

- Based on the profits of those companies, optimum profit of "Z" to be determined

- Entire actual profits of the group, that is profits of X, Y, Z, are to be aggregated.

- From the above, the optimum profits attributable to activities of "Y" & "Z", Optimum profit of "Y" & "Z" as determined earlier has to be deducted.

- The balance profit give the value of intangibles held by "X", which would indicate the optimum level of royalty to be paid by "Y"

V. Transaction Net Margin

- The Net Profit Margin realized is computed in relation to Costs incurred or sales effected or assets utilized.

- The Net Profit Margin realized by an Unrelated Enterprise from a comparable Uncontrolled transaction or group of transactions is computed.

- From this the Net Profit Margin is comparable uncontrolled transaction is adjusted to take into account the differences, if any, between the transactions being compared, which could materially affect the amount of Net Profit Margin in the open market.

- The Net Profit Margin thus established is then taken into account to arrive at Arm's Length Price in relation to International market.

BURDEN OF PROOF:

The primary onus is on the taxpayer to determine an arm's length price in accordance with the rules, and to substantiate the same with the prescribed documentation: where such onus is discharged by the assessee and the data used for determining the arm's length price is reliable and correct there can be no intervention by the Assessing Officer (AO). This is made clear in sub-section (3) of section 92C which provides that the AO may intervene only if he is, on the basis of material or information or document in his possession of the opinion that the price charged in the international transaction has not been determined in accordance with the methods prescribed, or information and documents relating to the international transaction have not been kept and maintained by the assessee in accordance with the provisions of section 92D and the rules made there under, or the information or data used in computation of the arm's length price is not reliable or correct ; or 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. If any one of such circumstances exists, the AO may reject the price adopted by the assessee and determine the arm's length price in accordance with the same rules. However, an opportunity has to be given to the assessee before determining such price. Thereafter, the AO may compute the total income on the basis of the arm's length price so determined by him under sub-section (4) of section 92C

ACCOUNTANT'S REPORT:

- Persons who enter into an international transaction during the previous year shall obtain report from an 'Accountant'

- The report should be submitted on or before October 31st of the relevant assessment year in case of company and on or before 31st July in case of other assessee.

- The report should be in the format as prescribed by the Central Board of Direct Taxes.

PENALTIES:

Concealment of Income or furnishing inaccurate particulars of income	**Min :** Tax amount sought to be evaded **Max :** 3 times the tax amount sought to be evaded
Failure to keep and maintain information and document	2% of the value of the international transaction
Failure to furnish report	Rs. 1 lac
Failure to furnish information and document	2% of the value of the international transaction

SOME INDIAN CASE LAWS:

1. MOSER BAER INDIA LIMITED

S 92CA (3) casts an obligation on TPO to accord an oral hearing to the assessee. The argument of the department that the failure to grant an oral hearing is a defect which could be cured by providing such an opportunity in the appellate forum is not acceptable. The show cause notice should also give an option to the assessee:

> **A.** To inspect the material available with the AO as to give the leeway to file further material or evidence if he so desires, and
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> **B.** To seek a personal hearing in the matter.

2. ESSAR SHIPPING LIMITED

The Tribunal held that comparable uncontrolled transaction may take the shape of any reliable data justifying the market price of similar services. It was observed that if the taxpayer was to rely on market report, the comparable cases should have been similar to the one to be tested. Thus in principle, the use of external publication as CUP was not drawn any adverse inference upon.

SOME PROBLEMS YET BEING FACED:

- Long way to go in understanding and adopting this approach
- Some MNCs still feel the threat of least safety
- MNC parents prefer to keep a co-ordinated integrated documentation approach to examine and to avoid paying tax more than required
- Though higher degree of sophistication is available, confusion remain as to which method to use
- In case of deemed associated enterprise, difficult in obtaining confidential information