



TRANSFER PRICING

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Abstract

Finance Act, 2001 has defined a hitherto ill-defined section/piece(?) of IT Act, 1961, ie., Transfer Pricing. This has enabled the tax laws dealing with International Transactions to effectively deal with the same.

The Finance Act, 2001 requires the computation of income from an international transaction having regard to the arm's length price so as to facilitate determination of proper income arising from international transactions where either or both the parties involved are non-resident. This comes in wake of the fact that tax avoidance can be managed by under or over-pricing goods and services between related parties due to arbitrage opportunities presented by different tax rates and regimes in different tax jurisdictions.

The Indian transfer pricing regulation is synopsized below.

Applicability

The transfer pricing regulation:

- Applies to an international transaction between two or more associated enterprises either or both of which are non-residents.

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- Applies even to an international transaction entered with a person other than an associated enterprise if there exists a prior agreement or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

Meaning of International Transaction

International transactions are widely defined and cover transactions 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 (e.g. patents, know-how, trademarks etc.)
- provision of services
- lending or borrowing money
- any other transaction having a bearing on the profits, income, losses or assets of such enterprise
- shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation of or 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.

Associated Enterprises

- An enterprise that participates directly or indirectly or through one or more intermediaries in the management or control or capital of the other enterprise.
- Enterprises under the same management or control

Situations under which two Enterprises shall be deemed to be Associated Enterprises

- Any person or enterprise holds either directly or indirectly shares carrying not less than 26% of the voting power in the other enterprise or in each of such enterprises.

- A loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the book value of the total assets of the other enterprise.
- An enterprise gives a guarantee of not less than 10% of the total borrowings of the other enterprise.
- More than half of the board of directors or members of the governing board or one or more of the executive directors or executive members of the governing board of one enterprise are appointed by the other enterprise or of each of the two enterprises are appointed by the same person.
- The manufacture or processing of goods or business carried out by an enterprise is wholly dependent on the use of know-how, copyrights or any other business or commercial rights of a similar nature or in respect of which the other enterprise has exclusive rights.
- The goods or articles manufactured or processed by an enterprise are sold to another enterprise or to persons specified by such other enterprise or where 90% or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by an enterprise are supplied by the other enterprise or by persons specified by such enterprise and the prices and the terms and conditions relating to such supply or sale are influenced by such other enterprise.
- An enterprise being a firm, association of persons or body of individuals and the other enterprise holds not less than 10% interest in such entities.
- There exists between the two enterprises any relationship of mutual interest.

Arm's Length Price

The arm's length price is the benchmark or reference price against which the price charged between related parties is measured. It is the price, which is applied or proposed to be applied in a transaction between persons other than, associated enterprises in uncontrolled conditions. In other words, it is a price at which a willing and able buyer will deal with a willing and able seller in independent circumstances without undue influence.

Uncontrolled Transaction

Transactions between enterprises other than associated enterprises whether resident or non- resident.

Steps for determining the arm's length price

- Identification of an international transaction (between related parties) and uncontrolled transaction.
- Identification and comparison of specific characteristics of international and uncontrolled transactions and determining whether the same are comparable by reconciling differences, if any.
- Selecting the most appropriate method of computing the arm's length price.
- Determining the arm's length price by applying the method chosen.

Criteria for Comparison of an International Transaction with an Uncontrolled Transaction

The following factors have to be taken into consideration while determining whether a controlled transaction can be compared with an uncontrolled one.

- Distinctive nature of property transferred or services provided (e.g. quality, value, presence of intangibles).
- Functions performed taking into account the assets employed or to be employed (e.g. design, development, manufacturing, warehousing, distribution).
- Risks assumed by the respective parties (e.g. financial, product, market and entrepreneurial risk).
- Contractual terms of the transaction (e.g. delivery and payment, discount, credit and warranty period, installation services).
- Market conditions (e.g. geographical location and size, regulatory laws, level of competition, nature of market and overall economic development).
- None of the differences between transactions or enterprises are likely to materially affect the price charged or profit arising from such transactions in the open market.

- Reasonable accurate adjustments can be made to eliminate material effects of differences.
- Data of the financial year in which the international transaction has been carried out.

For example, if SAP has a subsidiary in India, which exports software to its parent company and similarly, Oracle has an Indian subsidiary engaged in similar software export to its overseas holding company, the price at which SAP exports software cannot be compared with the price at which Oracle exports the software, as both the transactions are "controlled" between associated enterprises. Instead, the price at which SAP India exports to say, Coca Cola an unrelated party overseas, can be taken to be a reference price for determination of the arm's length price pertaining to SAP India.

Factors to be considered for the selection of the most appropriate method of determination of the arm's length price

- Nature and class of international transactions.
- Nature, class and functions performed by associated enterprises by taking into account the assets employed or to be employed and the risks assumed by such enterprises.
- Availability, coverage and reliability of data.
- Degree of comparability.
- Extent to which reliable and accurate adjustments can be made to account for the difference between the transactions.

Adjustments

If the arm's length price determined by the taxpayer is more than or less than 5% of the price determined by the assessing officer, adjustments shall be made in the income returned by an assessee.

Ordinarily, the associated enterprise is required to justify material departures from the arm's length price based on specific quantifiable and qualitative factors.

Methods for Computing the Arm's Length Price

Comparable uncontrolled price method:

Appropriate for transfer of goods, provision of services, intangibles, loans and provision of finance.

- Identify the price charged for property transferred or services provided in comparable uncontrolled transaction or a number of such transactions.
- Adjust the price to account for the differences between the international transaction and the comparable uncontrolled transaction or between enterprises entering into such transaction, which could materially affect the price in the open market.
- The adjusted price is the arm's length price.
- This price is compared with the price charged in the international transaction.
- Difference between the arm's length price and the actual price charged in the international transaction is to be adjusted to the price charged or paid in the international transaction.

Resale price method:

Appropriate for distribution of finished products or other goods involving no or little value addition.

- Identify the international transaction of purchases of property or services and identify the price at which the same are resold or provided to an unrelated party.
- Reduce the normal gross profit margin (margin which the enterprise would earn from purchase and resale of the similar product from and to an unrelated party).
- Reduce the purchase cost from the price so arrived at.
- Adjust the prices so computed for the differences between the uncontrolled transaction and the international transaction, which would materially affect the amount of gross profit margin in the open market.

- The adjusted price is the arm's length price.
- The difference between the arm's length price and the price charged in the international transaction should be adjusted in the returned income.

Cost plus method:

Appropriate for provision of services, joint facility arrangements, transfer of semi-finished goods and long term buying and selling arrangements.

- Determine the direct and indirect cost of production in respect of property transferred or service provided to an associated enterprise and identifies a comparable uncontrolled transaction or a series of transactions with an unrelated party for the same or similar property or service.
- Determine the gross profit mark up in the comparable uncontrolled transaction.
- Adjust the gross profit mark up to account for functional and other differences between the international transaction and the comparable uncontrolled transaction.
- The direct and indirect cost of production in the international transaction is to be increased by such adjusted gross profit mark up.
- The resultant amount is the arm's length price.
- The difference between the arm's length price and the actual price charged in the international transaction should be adjusted in the returned income.

Profit split method:

Appropriate for integrated services provided by more than one enterprise, transfer of unique intangibles and multiple inter-related transactions that cannot be separately evaluated.

- Determine the combined net profit of all associated enterprises engaged in the international transactions.
- Determine relative contribution made by each of them with regard to functions performed, assets employed, risks assumed and reliable external market data.
- Split the combined net profit in proportion to the relative net contribution.

- The profit so apportioned is taken to arrive at the arm's length price.
- The difference between the arm's length price and the actual price charged in the international transaction should be adjusted in the returned income.

Transactional net margin method:

Appropriate for provision of services, distribution of finished products where resale price method cannot be adequately applied and transfer of semi-finished goods.

- Identify the net profit (may be computed in relation to costs incurred or sales effected or assets employed or any other relevant base) margin realized by the enterprise from an international transaction and from a comparable uncontrolled transaction or a number of such transactions having regard to the same base.
- The net profit margin so identified is adjusted to take into account the differences, if any, which could materially affect the net profit margin in the open market between the international transaction and the comparable uncontrolled transaction.
- The adjusted net profit margin is taken into account to arrive at the arm's length price.
- The difference between the arm's length price and the actual price charged in the international transaction should be adjusted in the returned income.

For want of significant disclosure in financial statements and varied accounting treatments, the Indian experience in transfer pricing is largely based on the transactional net margin method, whereby the net profit margin forms the reference point for the arm's length price.

Documentation

Transfer pricing regulation requires the maintenance of extensive contemporaneous documentation, justifying the basis of arriving at the arm's length price. This includes:

- Description of the ownership structure of the assessee enterprise
- Profile of the multinational group of which the assessee enterprise is a part along with the enterprises of the group with whom international transactions

have been entered into by the assessee enterprise and the ownership linkages between them.

- Description of the industry in which the assessee operates and description of the business of the assessee together with a description of the business of the associated enterprises with whom the assessee has transacted.
- The nature and the terms of the international transaction entered into with each associated enterprise, details of the property transferred or services provided together with the quantum and value.
- Description of the functions performed, risks assumed and the assets employed or to be employed by the assessee and the associated enterprises involved in the international transaction.
- Record of the economic and market analyses or any financial estimate prepared by the assessee for the business as a whole and for each division or product separately which may have a bearing on the international transaction entered into by the assessee.
- Record of uncontrolled transactions, their nature, terms and conditions for analyzing their comparability with the international transaction.
- Record of the analyses performed to evaluate the comparability of uncontrolled transactions with the relevant international transaction.
- Description of the methods considered for determining the arm's length price in relation to each international transaction or class of transactions, the method selected as the most appropriate method, reason for the method selected and the manner in which the said method has been applied in each case.
- Record of the comparable data and financial information used together with a working of determination of the arm's length price and record of adjustments made for differences between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions.
- Assumptions, policies and price negotiations, if any, which have impacted the determination of the arm's length price.

- The adjustment made to the returned income in consequence to the reconciliation between the arm's length price and the price actually charged for the international transaction.
- Any other data that may be relevant for the determination of the arm's length price.

Normally, once a transfer pricing study involving the creation of documentation substantiating the pricing mechanism between associated enterprises is carried out in a given year, the same study can be made applicable in future years, unless there are changes in the facts and circumstances of the international transaction.

Transfer pricing is a recent tax phenomenon and can be used effectively as a tax-planning tool. There is therefore a need for companies to adapt and "bridge the gap".

Reference

1. Guidance note on Transfer pricing, published by the Institute of Chartered Accountants of India.