Transfer Pricing

Transfer pricing refers to the prices that related parties charge one another for goods and services passing between them. The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational groups by manipulating the prices charged and paid in such intra-group; transactions, thereby, leading to erosion of tax revenues.

With a view to provide a 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 Legislature has enacted transfer pricing provisions in the Income-tax Act. These provisions provide a comprehensive code relating to computation of income from international transactions having regard to arm's length price, meaning of associated enterprise, meaning of international transaction, determination of arm's length price, keeping and maintaining of information and documents by persons entering into international transactions, furnishing of a report from an accountant by persons entering into such transactions and definitions of certain expressions occurring in the said sections.

Transfer Pricing Regulations (TPR)

The Finance Act 2001 introduced Transfer Pricing Regulations (TPR) in India w.e.f April, 2001 corresponding to the assessment year 2002-03 (section 92 to 92F and rules 10A to 10 E and section 271 (1) (C), 271AA, 271BA and 271G) certain amendments were made in transfer pricing regulations corresponding to AY-2003-04. The exercise of amendments is carried out to remove inconsistencies, administrative problems and inconvenience besides widening the tax base. In line with the international income, the Finance Act 2001 introduced transfer pricing provision in the Income Tax Act, 1961 under chapter X and section 92 to 92F. The new transfer pricing provisions deviate little from the one by the Organization for Economic Co-operation and Development (OECD) in their report on transfer pricing and multinational enterprises. The Customs Valuation Rules, 1988 (CVR) also provide for transaction value of identical / similar goods, deductive value and computed value methods which are similar to valuation methods in the Transfer Pricing Rules under the Income Tax Act.

The basic intention underlying the transfer regulations is to prevent shifting of profits by manipulating prices charged or paid in international transaction; thereby eroding country's base. Article 9 of the OECD model treaty provides that the transfer price should be regulated so that they would reflect transfer prices that would have been set between unrelated enterprises acting independently. This is known as arm's length method and has been embodied in most tax treaties including model tax treaty issued by the United Nations.

The Indian legislation defines an Arm's Length Price (ALR) as one which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled situations. An arm's length transaction is one negotiated by unrelated entities, each acting in their own self-interest. It is a transaction in good faith in the ordinary course of business between entities with independent interests.

Under Income Tax Law

Section 92 A of the Income Tax Act.1962 (as Amended in 2001) provided for clarity in terms like International Transactions, Enterprise, Associated Enterprises etc which are essential for clothing various Multinational Enterprises within the gamut of direct taxation. The amended Act also provided for the methods by which the 'Arms Length Price' or the Price in which a related party has to transact has to be measured. Arms Length Price proposes that in an International Transaction the price at which unrelated or independent parties transact should be the price at which related entities transact. There are 5 methods by which the Arms Length Price is determined, The Comparable Uncontrolled Method (CUP), Resale Price Method (RPM), Cost Plus Method (CPM), Profit Split Method (PSM) and the Transactional Net Margin Method (TNMM) (S.92C). The Act provides for the determination of Arms Length Price by Assessing Officer or Transfer Pricing Officer (TPO) in case of trade of value INR 150 Million or more.

Under CUP method, the Arm's Length Price would be the price charged in comparable transactions by/to non-associated parties. This method is generally applied when market prices from uncontrolled transactions can be used directly to set transfer prices. Under the RPM method, the Arm's Length Price is determined by deducting an appropriate discount for the activities of the reseller from the actual resale price. The appropriate discount is the gross margin, expressed as a percentage of net sales, earned by a reseller on the sale of property that is both purchased and resold in an uncontrolled transaction in the relevant market. The RPM is generally used where one of the affiliated parties performs 'routine' distribution functions.

Under the CPM, the Arm's Length Price is determined by adding an appropriate mark-up to cost of production. The CPM is generally used where one of the affiliated parties performs 'routine' manufacturing options. 'Routine' functions typically involve standard services that can be contracted out and that can be readily priced using comparables. The PSM is based on the notion that profits earned on a given transaction should be equitably divided between the related parties involved in the transaction. The TNMM is used to compare assessee's net margins with other comparable companies. This method uses various 'profit level indicators' (such as return on costs or return on sales or return on capital employed etc) for comparisons.

The Transfer Pricing Officer (TPO) appointed under the Act should find the 'most appropriate method' (Rule 10 C(2) of Income Tax Rules, 1962) in determining ALP when none of the aforementioned methods does not apply, which is subject to the discretion of the Assessing or TP Officer as the case maybe. This proves to be negative as the TPO may not be efficient enough to determine the price in certain case. In the case of *Sony Pvt Ltd* v. *Central Board of Direct Taxes*,[1], evolved the question of reference in determining ALP to TPO.

Selection of the most appropriate method would depend upon the degree of comparability between the international transactions and the uncontrolled transactions and between the enterprises entering into such transactions. he taxpayer has been given the flexibility to choose the most appropriate method as he deem fit among those prescribed, but the appropriate method for a particular transaction would be determined with regard to the nature of the transaction, class of associated persons, functions performed by such persons, or such other relevant factors. The selection of the tested party precedes the selection of the most

[1] [2007] 288 ITR 0052.

appropriate method. Out of two associated enterprises, the tested party is generally the one, which is simpler of the two parties. The selection of the most appropriate method requires the taxpayer to analyze transfer prices under the method that provides the most reliable estimate of arm's length prices under the given circumstances.

The taxpayer (assessee) has to maintain adequate supporting information and documents in respect of all international transactions between associated enterprises. The Transfer Pricing Rule 10D prescribe the information and documents to be kept and maintained under Section 92D by persons entering into international transactions. Explanation 7 has been inserted in Section 271 of the Act to provide for levy of penalty for concealment of income, in a case where any amount is added or disallowed in computing the total income under section 92C(4). Section 271AA of the Act provides for penalty in a case where a person fails to keep and maintain any such information and document as required by section 92D. Section 271BA provides for a penalty where a person fails to furnish a report from an accountant as required by section 92E. Lastly, Section 271G levies penalty in a case where a person who has entered into an international transaction fails to furnish such information or document as required under Section 92D(3).

Under Customs Law

Article VII of the GATT and the WTO Agreement on Customs Valuation (ACV) do not explicitly deals wit the transfer pricing. In respect of transfer of goods between related parties, where the transaction value of identical/similar goods provides the basis for Customs Valuation when the relationship is found to have influenced the price. The Customs Valuation Rules, 1988 (CVR) also provide for deductive and computed value methods which are similar to RPM and CPM methods under the Transfer Pricing law. ACV Article 1.2 sets out a general principle that the transaction value shall be accepted provided that the relationship did not influence the price. To determine whether the relationship has influenced the price in any given controlled transaction, one has to compare such transaction with similar uncontrolled transaction. While the Income Tax authorities may seek to avoid diversion of profits to the exporting country by assessing lower transaction price on imports, the custom authorities as well as anti-dumping authorities would prefer to determine a higher transfer price to enhance customs revenue and anti-dumping duty.

Comparison between the Transfer Pricing Rules notified under the Income Tax Act and Customs Valuation Rules

There are several common areas in both systems and efforts could be made at national level to coordinate the approaches. The first three valuation methods of the Income Tax Act, namely, (a) comparable uncontrolled price method; (b) resale price method; and (c) cost plus method are very similar to the identical/similar goods value method, deductive value method and computed value method under the Customs Valuation Rules.

1. Under the CVR, the custom officer has the discretion to entertain doubt about the genuineness of the declared price and initiate a proceeding to verify the price under Rule 10A. In such a situation the burden proof is shifted to the assesse (importer). Though such a provision is missing in the transfer pricing rules, the burden of proof is always on the assessee and the tax office may determine the transfer price at its own discretion.

2. The Customs Valuation Rules (CVR) deal with the valuation of tangible goods only while the transfer pricing rules cover international transactions involving both tangibles and intangibles.
3. The categories of associated enterprises in transfer pricing rules are much wider in their scope than those specified for related parties under CVR. In CVR the relationship is defined under Rule 2 and is deemed to exist broadly in terms of ownership control of equity/stock or other controls. The transfer pricing rules have a much broader coverage and treat parties as related even on the grounds of consumption of raw material, dependence of patent, technology etc. The definition of "associated enterprises" includes multinational enterprises supplying technology to users world wide as associated enterprise (related parties). The use of technology could be by way of transfer of know-how, patents, copyrights trademarks, licenses franchises or any other business or commercial rights of similar nature. The definition excludes technology for services e.g. software from its scope.
4. The Income Tax Act provides for the application of the most appropriate method, whereas in CVR after the rejection of declared transfer price, the hierarchy of the Valuation methods must be followed strictly to re-determine the price for assessment.
5. CVR permits the acceptance of declared price if the relationship did not influence the price. In cases where it is held as influencing the price, the importer has the option to demonstrate, with the help of test values, that the declared price is closer to the arms length price. In transfer pricing rules, the arm's length price has to be determined by the application of any of the methods prescribed. Though the assessee can chose his own method for such a determination, the Assessing Officer, in the course of the assessment proceedings, can re-determine the arm's length price if he is of the view that the prescribed information is not maintained/furnished or data used for computing such price is not reliable or not in accordance with the prescribed provisions. However, the tax authorities shall not make any adjustments to the arm's length price adopted by the taxpayer if such price is up to 5% less or 5% more than such price determined by the Assessing Officer.

Possible Measures to Harmonise Transfer Pricing under Income Tax Law and Customs Law

1. Income Tax and Customs officials proceed independently to establish arm's length valuations in related-party import transactions. This may lead to different results which may be far from reality. Legislative action and agency cooperation should create an environment in which the Income tax and Customs authorities can coordinate import valuations as a unified force.
2. Harmonization of definition of 'related parties' is a possible solution. Under the Income transfer pricing rules treat enterprises as related even on the grounds of consumption of raw materials, dependence on patents, technology etc. whereas, the concept of relationship under CVR is limited. This difference between the CVR and transfer pricing rules could lead to one department treating the same transactions as between related parties and the other taking a contrary view. Thus, while customs may accept the declared price as at arm's length, the tax authorities may not and may reduce the declared price.
3. A very comprehensive Database is required for effective administration of transfer pricing policies,. There are several databases available with Income Tax and Customs departments, each of which provides information of a niche area. Sharing of information contained in these databases would be beneficial to both the departments in taking considered decisions as Transfer Pricing questions.

4. Income Tax and Customs Departments may also exchange data regarding adjustments/revisions made during assessments for uniformity in approach. It is also desirable to have joint action plan in important areas such as valuation rulings, documentation, and audit controls for effective coordination over the Transfer Pricing controls of Multinational Enterprises.
5. Documentation requirements under Income Tax Transfer Pricing are quite exhaustive. The documentation requirements under the Customs Valuation Rules are however not specific.
6. At present the Transfer Pricing under the Income Tax Act and Customs Department are administered by different authorities. For effective coordination between Customs & Income Tax Departments, it would be necessary to bring the same under the control of a single authority.
7. An institutional mechanism for harmonization and coordination of transfer pricing matters between Income Tax and Customs departments with adequate legal backing is desirable.

Conclusion

Transfer Pricing is an area, which is emerging as very important in the application of customs and income tax laws in India. This is on ascent with the increase in financial transactions with large number of Merger & Acquisition's (M&A's), opening of FDI and multifold increase in MNE transactions. Effective coordination between the Customs and Income Tax Departments by necessary legal and administrative provisions is urgently needed to improve the efficiency of transfer pricing administration not only for ensuring the interest of revenue but also for facilitating the trade and FDI. In *Commissioner of Income Tax (Appellate) in Aztech Computer case (Aztech Software & Technology Services Ltd.* v. *ACIT),*[2] it was observed that "Transfer Pricing is not an exact science, evaluation of transactions through which the process of determination is carried is an art where mathematical certainty is indeed not possible and some approximation cannot be ruled out, yet it has to be shown that analysis was 'judicial' and was done after taking into account all the relevant facts and circumstances of the case."

---

[2] 249 ITR (AT) 32.