TRANSFER PRICING

1. Introduction

Globalization of trade has bought with the advantage of, greater utilization of resources around the world give rise to variety of issues from commercial, business and tax prospective. Multi national companies have expanding their activity by the incorporation of subsidiaries in different countries and joint ventures with different groups.

The increasing participation of multinational groups in economic activities in a country give rise to new and complex issues emerging from international transactions. As a result of the inter group transaction across the border have caught the attention of the taxation authorities all over the globe. Therefore legislations have introduced Transfer Pricing regulation to restrict inter group companies from shifting profit from high tax authority jurisdiction to low authority jurisdiction,

The draconian effect of the transfer pricing can be felt by not only by multi national companies but also by small and medium sized business with future growth plan. The taxpayers and authorities have faced various complicated issues in transfer pricing. The India is now ready to accept the new techniques in transfer pricing already implemented by most of the developed tax jurisdiction like U.S.A, U.K.

2. Transfer Pricing

Transfer pricing is the term used to cover all aspects of the pricing between inter corporate cross borders transaction, including transfer tangible or intangible property, loans, services and other financing transaction.

Transfer Pricing Rules are applicable to all the enterprises that enter into an ‘International Transaction’ with an ‘Associated Enterprises’. Therefore, it generally applies to all the cross border transactions entered between Associated Enterprises. It even applies to the transactions involving a mere book entry having no apparent financial impact. The aim is to arrive at the comparable price as available to any unrelated party in open market conditions.

Many countries as a consequence of the globalization, felt that multi national companies makes an arrangement in such a way that they earn more profit in low tax jurisdiction. This is achieved by shifting cost or apportionment of cost or expense or under invoicing or over invoicing or other innovative plans. To stop these practices, the Article 9 of the OECD model convention gives the right to make transfer pricing adjustment by a country in income or cost related to international transaction.

The Government of India also enacted laws effective from Financial Year 2001-2002 by which rules have been framed to determine income arising from an international transaction or the cost of transaction between associated enterprises to computed having regard to Arm Length Price

2.1 International Transaction

An international transaction is essentially a cross border transaction with Associated Enterprises in any sort of property, whether tangible or intangible, or in the provision of services, lending of the money etc. At least one of the party to the transaction must be a non resident entering into one of the following transaction:

- Purchase, sale or lease of tangible or intangible property
- Provision of services
- Lending or borrowing of money
- Any other transaction having a bearing on the profits, income, losses or asset
- Mutual cost sharing agreement

2.2 Associated Enterprises (AE)

The basic criteria to determine an AE is the participation in management, control or capital (ownership) of one enterprise by another enterprise. The participation may be direct or indirect or through one or more intermediaries.

The concept of the control adopted in the legislation extends not only to control through holding shares or voting power or power to appoint the management of the enterprise but also through debt, relatives and control over the various component of the business actively performed by taxpayer such as control over raw material, sales and intangible.

2.3 Arm Length Principle

A deal between two inter- related or associate enterprises. That is behavior as if they were not related, so that there is no query of disagreement of attention. In simple way we can describe as, “a deal between two unconnected enterprise or uncontrolled price”.

The ‘arm length principle’ of transfer pricing states that the amount charge by one related party to other must be same as if the party is not related. An arm length price of that transaction would be uncontrolled price.

3. Indian Tax authorities

Internationally accepted method of transfer pricing like Arm Length Price, statistical tools and Advance Pricing agreement (APA) and applicability of range vis a vis an arithmetic means are some illustrative development. The increasing number of litigation and high administrative cost has cause the Central Board of Direct Tax to suggest the implementation of these methods

The Indian Income Tax authority usually show aggressive stand on transfer pricing. Such strict approach of the income tax authority may restrict multinational companies from entering into the business in India.

But recently, the income tax authority proposed the measures like Safe Harbour, Alternative Dispute Resolution in the budget that would reduce the hardship on taxpayer of going current appellate process, reduce litigations, reducing administrative cost and bring certainty in transfer pricing issues.

4. Computation of Arm Length Price

The most important aspect of the transfer pricing is the computing Arm Length Price in a cross border transactions. The price that would charge by one related party to another must be same as if it had been entered into by unrelated party in similar conditions. The Arm’s Length Price shall be determined by the methods specified in Income tax provisions.

Five methods have been prescribed to determine Arm Length Price:

- Comparable uncontrolled price method

- Resale price method
- Cost plus method
- Profit split method
- Transactional net margin method
- Such other method as may be prescribed by Board

The taxpayer can select the most appropriate method to be applied to any given transaction, but such selection has to be made on taking into the account factors prescribed in the law. The rules have laid down a detailed set of procedures for computing the Arm Length Price in each of the methods. The rules also prescribed the various factors to be considered in determining appropriate method, the documents are to be made and the format of the report.

When one or more price is determined by the most appropriate method, the Arm Length Price shall be taken to be the arithmetic mean of such prices. However, if the arithmetic mean of such prices is with in the band of 5% of the transfer pricing then arithmetic means shall be considered as Arm Length Price.

5. Burden of proof on Tax Payer

The primary responsibility is on the taxpayer to determine Arm Length Price in accordance with the Transfer Pricing Regulation. Where such data used for determining the Arm Length Price is reliable and correct there can be no intervention by the tax officer.

In the following cases, tax officer may reject the Arm Length Price:

- price charged in international transaction has not been determined in accordance with the method prescribed,
- or information and documents relating to international transaction have not been kept and maintained by the assessee in accordance with Transfer Pricing Regulation,
- or information or data used in the computation of the Arm Length Price is not reliable,
- or assessee has failed to furnish any information or document which he was required to under Transfer Pricing Regulation

For this purpose, he would then refer the matter to the Transfer Pricing Officer who would determine the Arm Length Price after hearing the argument of the assessee.

6. Appeals / Remedies available to Taxpayer

Normally, the taxpayer facing the transfer pricing adjustment is required to go through a normal appeal process to the Commissioner of Income Tax and then to the tribunal and further to courts.

6.1 Alternative Dispute Resolution

Recently, the budget has proposes the Alternative Dispute Resolution applicable from 1st October, 2009.

- Eligible Taxpayer
  a) Foreign Companies
  b) Person having transfer pricing variation

Any taxpayer aggrieved by a proposed transfer pricing adjustment, and any foreign company can file objections to the proposed adjustment before dispute resolution panel with in 30 days of the Draft order being provided by the Assessing Officer to the Assessee.

The panel will issue directions for confirming, reducing or enhancing the adjustment proposed by the revenue authorities with in 9 months of the Draft order being provided by the Assessing Officer to the Assessee.

The panel's directions are binding on the revenue authorities. The taxpayer has a further option to appeal before a tribunal in case of an adverse direction from the panel.

6.2 Mutual Agreement Procedure

Mutual Agreement Procedure (MAP) is a mechanism to resolve disputes regardless of the remedies available in domestic law. The MAP provisions are covered in the Double Taxation Avoidance Agreement that India has with various countries.

Broad Categories of the Disputes covered in MAP:

- Specific Case Provisions – Specific cases of the taxation not in accordance with Double Taxation Avoidance Agreement
- General Provisions - Interpretation of the terms in the treaty
- Elimination of double taxation not provided in DTAA

The Transfer Pricing is expected to be a common ground for disputes under MAP. The companies are hesitating to take the benefit of MAP due to some inherent limitation. The MAP process is time consuming.

7. Safe harbour

The arm length price shall be determined subject to Safe harbour rules. The Board has empowered to formulate Safe harbour rules, that is, to determine the circumstances in which revenue authority will accept the transfer price declared by the taxpayer.

Safe harbour rules will help to achieve the objective of compliance relief, administrative simplicity. While the parameter and scope of the Safe harbour will be determined by the board with in a few months.

The basic problem which is faced by companies in India is finding comparable data for documentation as required by Indian regulation. The lack of acceptable data restricts companies to comply the transfer pricing requirements effectively. Therefore, in the absence of the transaction information of third party, the comparison between the transaction of the third party and taxpayer is next to impossible as it is mandate in Indian law.

The Indian transfer pricing regime has the advantage of learning with the experience of other tax jurisdiction, which have more than two decades of experience and to incorporate similar provision in India Tax Law enable the country to attain new heights of competence in the high competitive global platform.