TRANSFER PRICING

In the present age of commercial globalisation multinational companies have branches/ divisions/ subsidiaries operating throughout the glob. In such conditions it is common for MNCs to transfer goods produced by one branch in one jurisdiction to an associated branch in another tax jurisdiction. While doing so the MNC concerned has in mind the goal of minimizing tax and maximizing profits.

Transfer Pricing- Meaning

Transfer pricing refers to the prices that related parties charge one another for goods and services passing between them. For example if a company, X manufactures goods and sells them to its sister concern Y in another country the price at which the sell takes place is known as the transfer price.

From tax perspective the transfer price is the price that is arrived at when two associated enterprises or related parties deal with each other in order to manipulate the price in a manner whereby the profits are transferred to the entity of that country where the tax rates are lower. For example, suppose, the only transaction between a holding company and a subsidiary company in different country involves the holding company's transfer of manufactured goods at a price equal to the cost price of Rs. 600 each, and subsidiary company resells it for Rs. 1200 each, and if the tax rate of the subsidiary is lower or zero, then the holding company can easily escape payment of tax. Hence most countries have transfer pricing rules which regulates the prices charged by related persons.

Transfer Pricing Regulations

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.A.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. It involves treating each constituent unit of MNC, which can be a subsidiary or a branch as a separate taxable entity and reconstructing its income, based on hypothetical transactions that would have taken place had the unit been dealing with other portions of the MNC at arm's length. In other words the underlying principle is that the prices charged by related parties to one another should be consistent with the price that would have been charged if both parties were unrelated and negotiated at arm's length.

Transfer Pricing Provisions in India

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.

Transfer pricing provisions provide a statutory framework for computation of reasonable, fair and equitable profits and tax in India in the case of multinational enterprises.

The provisions of transfer pricing shall be applicable if the following conditions are fulfilled:

i. There must be an international transaction.
ii. Such transaction should be between two or more associated enterprises either both of whom are non-residents.
iii. Such international transaction should be in nature of :
    a. Purchase, sale or lease of tangible property or
    b. Provision of service or
    c. Lending or borrowing money or
    d. Any other transaction having a bearing on the profits, income, losses or assets of such enterprises.
iv. Such transactions may also involve allocation of contribution to any cost on the basis of mutual agreement between such associated enterprises.
v. Such international transaction must not be done at arm's length price.
vi. The above adjustment must result either in an increase of income or decrease of loss by assessee

International Transaction

International transaction means transaction between two or more associated enterprises, either or both of whom non-residents and such transaction are in the nature of purchase sale of property or provisions of service or lending and borrowing money.

Associated Enterprises

An enterprise shall be an associated enterprise if it falls under the situations covered under section 92A. Let's discuss some situation where an enterprise is an associated enterprise;

● Where an enterprise participates in the management, capital or control of other enterprise then, the other enterprise regarded as associated enterprise; or

Example: X Ltd. Participates in the management or control or capital of Y Ltd. In this case Y Ltd. shall be associated enterprise of X Ltd.

● Where one or more persons participates in the management, capital or control of one enterprise and the same persons also have same privilege in other enterprise than both of these enterprise are associated enterprises;

Example: A Ltd. participates in management or control of X Ltd and y Ltd. then X ltd. and Y ltd. are associated enterprise along with A ltd, X ltd and Y ltd are associated enterprises amongst themselves.
Section 92A(2), enlists 13 situations in which two enterprises shall be deemed to be associated enterprise.

Arm's Length Price

"Arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. It is the price which would have prevailed between enterprises, not associated or related with each other.

Computation of Arm's length price

Arm's length price can be determined on the basis of any of the following methods;

(i) Comparable uncontrolled price method (CUPM)
(ii) Cost plus method (CPM)
(iii) Resale price method (RPM)
(iv) Profit split method (PSM)
(v) Transactional net margin method (TNMM)
(vi) Such other method as may be prescribed by the board.

Before selecting any method, the following procedure should be followed:
(i) Identify the international transaction
(ii) Also identify a transaction between enterprises other than associated enterprises.
(iii) Compare the international transactions with uncontrolled transactions.
(iv) If there are deviations then calculate the Arm's length price by applying the most appropriate method.