Transfer Pricing

Overview of TP Regulation in India

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Need for TP Regulations

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Why Transfer Pricing?

Increasing participation of MNC's in various countries has given rise to new and complex issues arising from intra-group cross-border transactions

Profits derived by such intra-group entities can be controlled by the Group by manipulating the price leading to erosion of revenues

To curb such tax avoidance by abuse of TP and to ensure fair and equitable sharing of tax revenues b/w tax nations, the need of TP Regulations arise

Accordingly, India has also introduced the TP Regulations first time in AY 2002-03 vide Finance Act, 2001 and has amended from time-to-time

Scenario-1

Singapore Tax Rate :: 17%

Sale of Goods to India	US$ 4,000	Tax in Singapore
Cost of Production	US$ 3,000	
Profit to Singapore Co.	US$ 1,000	US$ 170

India Tax Rate :: 30%

Sale of Goods to 3rd Party	US$ 6,000	Tax in India
Cost of Purchase from SG	US$ 4,000	
Profit to Indian Co.	US$ 2,000	US$ 600

Sale to 3rd Parties in India

Total Tax paid by the MNC Group in Singapore and India :: US$ 770

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Scenario-2

Singapore Tax Rate :: 17%

Sale of Goods to India	US$ 5,000	Tax in Singapore
Cost of Production	US$ 3,000	
Profit to Singapore Co.	US$ 2,000	US$ 340

India Tax Rate :: 30%

Sale of Goods to 3rd Party	US$ 6,000	Tax in India
Cost of Purchase from SG	US$ 5,000	
Profit to Indian Co.	US$ 1,000	US$ 300

Sale to 3rd Parties in India

Total Tax paid by the MNC Group in Singapore and India :: US$ 640

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02

Concept of Transfer Pricing

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Concept of Transfer Pricing

Section-92(1) (Charging Section):

- Any income arising from an international transaction shall be computed having regard to the Arm's Length Price (ALP).
- **Explanation:** the allowance for any expense or interest arising from an international transaction should also be determined having regard to the ALP (E.g.: Imports from AEs).

Section-92(3) (Proviso):

- The TP provisions are not intended to be applied in case determination of ALP reduces the income chargeable to tax or increases the loss, as the case may be.
- Therefore, If income as per the books of accounts is higher than income as per ALP, then no adjustment can be made to reduce the taxable income.
- **CBDT's Circular No. 8/2002:** This may be due to the fact that Indian TP regulations aim to protect erosion of India's tax base.

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Concept of Transfer Pricing

Transfer Price - Meaning and Purpose:

- Transfer Price refers to the price charged by one member of multinational organization to another member of the same organization for the provision of goods or services or the use of a property, including intangible property.
- Transfer price is significant for both the taxpayers as well as the tax administrations, because it affects the allocation of profits from intra-group transactions, which impacts the income and expenses reported, and therefore taxable profits of related companies that operate in different taxing jurisdictions.

Arm's Length Price (ALP):

- **Section-92F:** ALP means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.
- This concept of ALP is based on the premise that the amount charged by one related party to another for a transaction must be the same as if the parties were not related i.e. the price which the transaction would have obtained in the open market.

03

Associated Enterprise(s)

Meaning of Associated Enterprise(s)

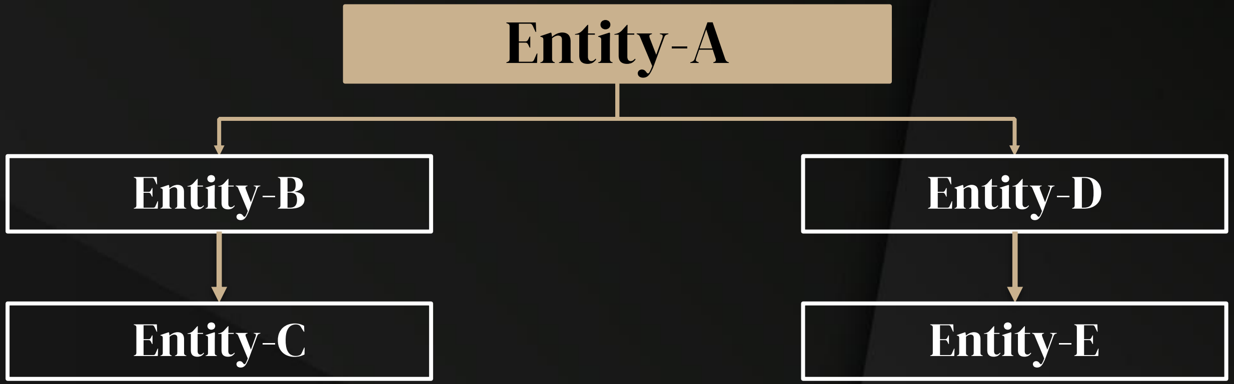
Associated Enterprise(s)

- **Section-92A(1): Broad definition**
- **Section-92A(2): Deemed AE**

Meaning of Associated Enterprise(s)

Section-92A(1) (Broad definition): Two enterprises shall be considered as AE to each other, if:

- One enterprise participates directly or indirectly in the management / control / capital of the other enterprise; or
- Same enterprise participates directly or indirectly in the management / control / capital of both the enterprises
- E.g.:



Meaning of Associated Enterprise(s)

Section-92A(2) (Deemed AE): Circumstances in which, two enterprises shall be deemed to be "AE", if at any time during the PY:

- **One enterprise holds**, directly or indirectly, at least **26% voting power** in the **other enterprise**;
- **Same person / enterprise holds**, directly or indirectly, at least **26% voting power** in both the enterprises;
- **One enterprise advances loan** to the other enterprise, at least **51% of the book value of the total assets** of such other enterprise;
- **One Enterprise guarantees**, at least **10% of total borrowing** of the other enterprise;
- More than "**50% of Board of Directors**" or "**one or more executive directors**" of one enterprise are appointed by the other enterprise;
- Same person appoints more than "**50% of Board of Directors**" or "**one or more executive directors**" of both the enterprises;
- The business of **one Enterprise is wholly dependent on use of intangibles owned by other enterprise** such as patents, copyright, trademark or any other business or commercial rights, etc.;

Meaning of Associated Enterprise(s)

Section-92A(2) (Deemed AE): Circumstances in which, two enterprises shall be deemed to be "AE", if at any time during the PY:

- At least **90% of raw material and consumables required by one enterprise are supplied by the other enterprise** (or the person specified and influenced by such other enterprise);
- The **goods manufactured or processed by one enterprise are sold to the other enterprise** (or person specified) and the prices and other conditions are influenced by such other enterprise;
- Both the enterprises are controlled by the common individuals and/or their relatives;
- Both the enterprises are controlled by the common HUF and/or their members / relatives;
- Where on enterprise is a firm or AOP or BOI, and the other enterprise holds at least 10% interest in such firm or AOP or BOI;
- There exists between the two enterprises, any relationship of mutual interest as may be prescribed. (However, nothing has been prescribed in this regard till date).

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Meaning of Associated Enterprise(s)

In order to constitute the relationship of AEs, whether the conditions laid down in Sections 92A(1) & 92A(2) are to be satisfied simultaneously or only one condition is sufficient to determine the AE relationship?

- The words used in the Section-92A(2) are “for the purposes of sub-section (1)”, it means that sub-section (2) is not independent and it has to be read with sub-section (1) only.
- As per the amendment made by the Finance Act, 2002 in section-92A(2) read with the Memorandum which explains that “mere satisfaction of conditions specified in sub-section (1) shall not make them AEs unless the criteria specified in sub-section (2) are fulfilled.”
- **Based on the above, it appears that the sub-section (2) is dependent on sub-section (1), and to constitute the relationship of AE, conditions of both the sub-sections (1) & (2) need to be satisfied.**
- However, the possibility of the transfer pricing authorities taking a contrary view cannot be negated and therefore litigation cannot be ruled out.

04

International Transactions

International Transactions

Section-92B(1) (Definition of International Transactions):

- International Transaction means a **transaction between two or more associated enterprises, either or both of whom are non-residents.**

Explanation to Section-92B:

- In the explanation to Section-92B, the term 'International Transaction' has been **exhaustively defined** to mean a transaction, between two or more AEs, either or both of whom are Non-Residents.

Conditions to constitute an International Transaction:

- There should be **a transaction**;
- Transaction should be **between two or more associated enterprises**;
- **At least one** of the **Associated Enterprises** in the transaction should be **Non-Resident**;

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International Transactions

Section-92B(1) read with the Explanation: The expression "International Transaction" shall include:

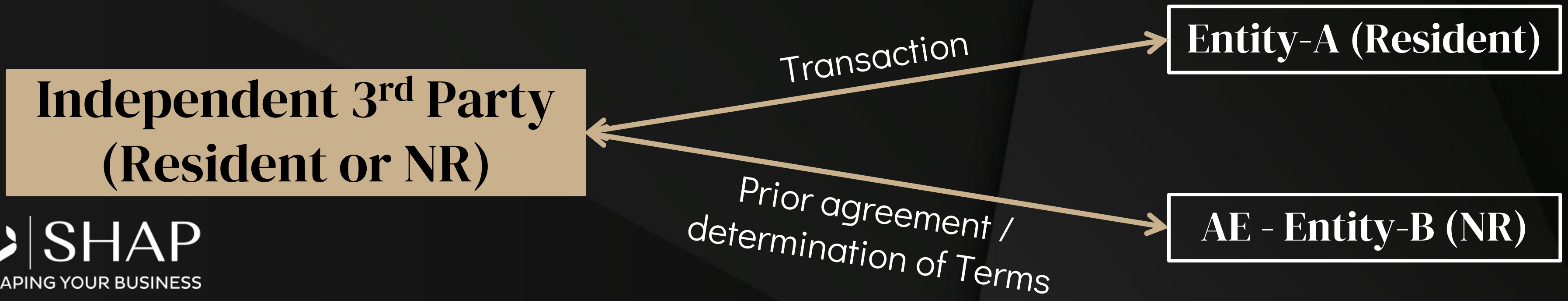
- **Purchase / Sale / Transfer / Lease / Use of Tangible Property:** It includes Buildings / Vehicles / Machinery / Furniture / Commodities etc.;
- **Purchase / Sale / Transfer / Lease / Use of Intangible Property:** It includes Transfer of Ownership / Use of Rights for all kind of Intangible Properties and Business or Commercial rights;
- **Capital Financing:** It includes "long-term or short-term" Borrowing / Lending / Guarantee / Purchase or Sale of Marketable Securities / Provision or receipt of advances etc.;
- **Provision of Services:** It includes services relating to Market Research / Market Development / Administration / Technical / Scientific / Legal / Accounting / Consultation etc.;
- **Business Restructuring or Reorganization:** It will be included irrespective to the fact that it has any bearing on the profit, income, losses or assets of the enterprises;
- **Mutual Agreement / Arrangement:** Allocation / Apportionment / Contribution for cost or expenses;
- **Any other:** Any transaction having a bearing on the profit / income / losses / assets of the enterprises.

International Transactions

Section-92B(2) (Deemed International Transactions): a transaction entered into by an enterprise with an independent 3rd party can also be deemed to be an international transaction, if:

- There is a **prior agreement** in relation to the transaction under consideration **between the independent 3rd party and the AE** of the enterprise; or
- The **terms of the transaction** under consideration are **determined in substance between the independent 3rd party and the AE** of the Enterprise.

To constitute a Deemed International Transaction, at least one of the Enterprise or AE should be NR in India irrespective to the fact whether the Independent 3rd party under consideration is resident or NR.



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05

Specified Domestic Transactions (SDTs)

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Specified Domestic Transactions

Section-92BA: The SDT means any of the following transactions, (not being an International Transaction):

A — Transactions covered u/s 80A

B — Transfer of goods or services covered u/s 80-IA(8)

C — Business Transaction with person covered u/s 80-IA(10)

D — Any transaction under Chapter VI-A or Sec-10AA, to which Sec 80-IA(8) and Sec 80-IA(10) applies

E — Any business transaction between persons covered u/s 115BAB(6)

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Specified Domestic Transactions

Threshold Limit for applicability of SDTs:

- All the transactions covered under the 5 limbs of Section-92BA will be regarded as Specified Domestic Transactions only if the aggregate value of all such transactions in the Financial Year under consideration exceeds the threshold limit of INR 20 Crores.

- If the threshold limit is crossed in aggregate, the Transfer Pricing compliances are required for all the SDTs covered under section 92BA.

06

Computation of ALP

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Computation of Arm's Length Price

Section-92C:

- The Arm's Length Price (ALP), in relation to an international transaction or a specified domestic transaction, shall be determined by any of the following methods, (being the "Most Appropriate Method"):
    - Comparable uncontrolled price method (CUPM);
    - Resale price method (RPM);
    - Cost plus method (CPM);
    - Profit split method (PSM);
    - Transactional net margin method (TNMM);
    - Residual Method - Other Method as prescribed by the board (Rule-10AB)

- The "Most Appropriate Method" shall be decided having regard to the "Nature of Transaction" or "Class of Transaction" or "Class of Associated Enterprises" or "Functions Performed" etc.

Computation of Arm's Length Price

Comparable uncontrolled price method (CUP Method):

- Where it is possible to locate comparable uncontrolled transactions, then in such cases, CUP method is the most direct and reliable way to apply the arm's length principle and preferable over all other methods.

- ALP shall be determined by the CUP method in the following manner:
  - **Identify the price** charged, or paid, for property transferred, or services provided, in a **comparable uncontrolled transaction**, or a number of such transactions;
  - Such **price is adjusted to account for differences**, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions;
  - Such **adjusted price is considered to be the ALP** in respect to the international transaction or the specified domestic transaction under consideration.

- Where the CUP method and any other TP method can be equally applied reliably, then the CUP method is to be preferred over any other method.

Computation of Arm's Length Price

Resale price method (RPM):

- This method is probably most useful when it is applied to **distribution or marketing activities** when the goods are **purchased from AEs** and there are sales effected to unrelated parties without any further processing and the reseller does not add any value to products.

- In other words, RPM is suitable when the reseller adds relatively little value to the goods and does not alter the goods physically before the resale. Packaging, re-packaging, labeling or minor assembly does not ordinarily constitute physical alteration.

- In RPM, gross profit margin earned in a controlled transaction is being compared with the gross profit margin earned in a comparable uncontrolled transaction to determine ALP. RPM is based on the price at which a product is purchased from a related party and resold to an unrelated enterprise.

- In case of application of RPM as "Most Appropriate Method", Internal RPM is generally preferred over external RPM due to availability of more reliable and accurate data.

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Computation of Arm's Length Price

Cost Plus Method (CPM):

- CPM determines ALP of a controlled transaction by reference to the gross profit mark up on the direct and indirect costs of producing products or rendering services that is realized in comparable uncontrolled transactions.

- CPM is the most useful when there are transactions pertaining to:
  - Sale of Semi-finished goods;
  - Rendering of services;
  - Contract Manufacturing;
  - Joint facility agreements;
  - Long-term-buy-and-supply arrangements.

- Also, In case of application of CPM as "Most Appropriate Method", Internal CPM is generally preferred over external CPM due to availability of more reliable and accurate data.

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Computation of Arm’s Length Price

Profit Split Method (PSM):

- PSM is mainly applicable for the international or specified domestic transactions pertaining to:
  - Transfer of unique intangibles;
  - Multiple number of international or specified domestic transactions are there, which are so interrelated that they cannot be evaluated separately for the purpose of determining the ALP of any one transaction;

- This method first identifies the profits to be split from the controlled transactions and then splits them between the AEs on an economically valid basis that approximates the division of profits that would have been agreed at arm’s length. The aim is to ensure that profits of the AEs are aligned with the value of their contributions and the compensation which would have been agreed in comparable transactions between independent enterprises for those contributions.

- The objective of this method is to approximate as closely as possible the split of profits that would have been realized or earned to each party if they would have been independent enterprises.

Computation of Arm’s Length Price

Transactional Net Margin Method (TNMM):

- TNMM is actually the method most widely used in actual practice.

- TNMM examines the net profit margin relative to an appropriate base (i.e. costs, sales, assets etc.) that a tested party earns from a controlled transaction with the net profit margin earned from comparable uncontrolled transactions (Internal TNMM) or with that of an uncontrolled party engaged in a comparable uncontrolled transaction (External TNMM).

- TNMM compares net margins by using financial ratios being called as Profit Level Indicators (PLIs) to express profit margins earned as a % of a given base which commonly includes operating cost, operating income, total assets, operating expenses, etc. (i.e. “Operating Profit divided by Operating Cost” or “Operating Profit divided by Operating Revenue” etc.).

- However, the TNMM is considered as a method of last resort and is applied when it is not possible to apply any other methods as mentioned earlier to determine ALP.

Computation of Arm's Length Price

Other Method as prescribed under Rule-10AB:

- CBDT has inserted a new Rule-10AB to notify the "Other Method" for computation of ALP, apart from the 5 methods prescribed originally.

- The other method prescribed under Rule-10AB takes into account, "the price which has been charged or paid", or "would have been charged or paid", for the same or similar uncontrolled transaction with, or between, non-AEs under similar circumstances considering all the relevant factors for computation of ALP.

- This 'Other Method' can only be applied, where the application of 5 specific methods is not possible due to reasons such as difficulties in obtaining comparable data due to uniqueness of transactions such as intangibles or business transfers, transfer of unlisted shares, sale of fixed assets, revenue allocation / splitting, guarantees provided and received, etc. However, it would be necessary to justify and document appropriate reasons for rejection of all other 5 methods while selecting the 'Other Method' as the "Most Appropriate Method".

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Thank you

Do you have any questions?

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Note: Useful references have been drawn from “Pithisaria & Pithisaria's Law & Practice of Income Tax” in 3 Volumes [2022 Edition] co-authored by our Partner CA Abhishek Pithisaria and is published by the Taxmann.