Transfer Pricing: The Indian Experience

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Since the economic reforms signaled in 1990-91,there has been a globalization and maturing of Indian economy. Each year has seen the entry of new multinationals (MNCs) into the country, and domestic companies growing into conglomerates by adding products and locations. A large number of MNCs made their presence felt on the Indian shores for the first time. Reverse has also been true, many Indian companies have also set up their operations outside the country. Sheer coincidence, technology and competition came at the center stage. These two environmental factors greatly impacted the organizational structure and culture.In the brave new world, the convergence of information, telecommunications and broadcasting has led to the spread of Internet. The web-based interconnectivity has blurred the business borders across the globe, unthinkable a few years ago. The online business has further energized the cult of MNCs and conglomerates. The transfer pricing became the key accounting issue in this backdrop.

TRANSFER PRICE

Transfer prices are the prices at which an enterprise transfers physical goods and Intangible property or provides services to associated enterprises. Horngren and Foster defined transfer price as "The price one segment of an organization (Subunit, department, division and so on) charges for a product or service supplied to another segment of the same organization'. A slightly modified version of this definition would include intercompany transfers between affiliates. Transfer pricing affects almost every aspect of operations of MNCs. When one considers that more than one – third of all cross border sales of goods and services worldwide occur between related units of MNCs, the enormity of transfer pricing issue will be apparent.

Virtually all developed countries and many under developed countries including India have some sort of transfer pricing provisions in their text codes. In essence, all transfer pricing legislations give tax authorities the power to examine the price charged in a transaction between related persons .If the price so charged is not market price, the authorities have the power to substitute the market price in place of price actually charged. The type of transaction to which these regulations apply include not only supplies of materials, components and finished products, but also payments for intangibles such as management fees, intellectual property royalties, interest on loans, payment for technical assistant and know how etc.

When MNCs operates in the host country through a branch, there is no transfer pricing as such between the branch and head office or other divisions of the same company, since it cannot enter into transactions with itself. In the case of branch, the relevant exercise is to determine how much revenue and expenditure should be allocated to the branch. In doing so, principles similar to those involved in transfer pricing are frequently applied. However, transfer pricing could occur between the branch and a separate (related) company, such as a subsidiary of MNCs. The intention behind transfer pricing rules is obvious –without them, MNCs could – and usually – would adjust their intra-group transaction in such a way as to maximize their taxable profits in low –tax jurisdictions and minimize them in high tax jurisdictions. These rule permit tax authorities to counter such practices by substituting an Arm's length price for the price actually realized by the parties.

In consequence, transfer pricing has became a matter of great concern for the tax authorities and the MNCs. India, too realizing the potential for collecting its due share of revenue from MNCs, set up in November 1999 and expert group under the chairmanship of Shree Raj Narain, to formulate the transfer pricing regulation in India. This group submitted its report in January 2001. On the basis, the finance act 2001 has introduced detailed transfer pricing regulations vide sections 92 to 92F of the Income tax act 1961. These rules are applicable with effect from assessment year 2002-2003. The objectives behind introduction of the provisions as stated by finance minister in his budget speech are reproduced below.

"The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra- group transaction has made the issue of transfer pricing a matter of serious concern, I had setup an expert group in November 1999 to examine the issues relating to transfer pricing. Their report has been received, proposing a detailed structure for transfer pricing legislation. Necessary legislative changes are been made in the finance bill based on these recommendations" (Para 176).

ARM'S LENGTH PRINCIPLE

The OECD has also almost all countries with transfer pricing regulations in place, have recognized the Arm's length principle. This principle suggests that to associate enterprises (AEs) should be treated as independent enterprises and all transactions would be considered at market price. In other words, various units of the members of the MNC group would be treated as separate entities rather than inseparable parts of a single unified business enterprise. This principle is incorporated in article 9 of the OECD model convention. Para 1 of the article 9 provides that transactions between AEs should be evaluated as if they are independent of each other and if it is found that owing to special conditions between two countries, prices are not comparable with those of the independent enterprises, then suitable adjustment would be made for the price differential.

NEW LEGISLATION

Under the existing section 92 of the income–tax Act, which was the only section dealing specifically with cross border transaction, and adjustment could be made to the profits of a resident arising from a business carried on between the resident and a non resident, if it appeared to the Assessing officer that owing to the close connection between them, the course of business was so arranged so as to produce less than expected profits to the resident. Rule 11 prescribed under the section provided a method of estimation of reasonable profits in such cases. However, this provision was of a general nature and limited inscope. It did not allow adjustment of income in the case of non-residents. It referred to a "close connection" which was undefined and vague. It provided for adjustment of profits rather than adjustment of prices and the rule, prescribed for estimating profits was not scientific. It also did not apply to individual transactions such as payment of royaltyetc, which are not part of a regular business carried on between a resident and a non- resident. There were also no detailed rules prescribing the documentation required to be maintained.

With a view to provide a detailed 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 Act has substituted section 92 with a new section, and has introduced new sections 92A to 92F in the Income – tax Act, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of international transaction, computation of arm's length price , maintenance of information and documents by persons entering into international transactions, furnishing of a report from an accountant by persons entering into international transactions and definitions of certain expressions occurring in the said sections.

The newly substituted section 92 provides that income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price. Any expense or outgoing in an international transaction is also to be computed having regard to the arm's length price. Thus in the case of a manufacturer, for example, the provisions will apply to exports made to the associated enterprise as also to imports from the same or any other associated enterprise. The provision is also applicable in a case where the international transaction comprises only an outgoing from the Indian assesse.

The new section further provides that the cost or expenses allocated or apportioned between two or more associated enterprise under a mutual agreement or arrangement shall be at arm's length price. Examples of such transactions could be where one associated enterprise carries out centralized functions which also benefit one or more other associated enterprise, or two or more associated enterprises agree to carry out a joint activity, such as research and development, for their mutual benefit.

The new provision is intended to ensure that profits taxable in India are not understated (or losses are not overstated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances. The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. The new section 92 is,therefore, not intended to be applied in cases where the adoption of the arm's length price determined under the regulations would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

The substituted new sections 92A and 92B provide meanings of the expressions "associated enterprise" and "international transaction" with reference to which the income is to be computed under the new section 92. While subsection (1) of section 92A gives a general definition of associated enterprises, based on the concept of participation in management, control or capital, sub-section (2) specifies the circumstances under which the two enterprises shall be deemed to be associated enterprises.

Section 92B provides a broad definition of an international transaction, which is to be read with the definition of transaction given in section 92F. An international transaction is essentially a cross border transaction between associated enterprises in any sort of property, whether tangible or intangible, or in the provision of services, landing of money etc. At least one of the parties to the transaction must be a non-resident. The definition also covers a transaction between two non-residents, where for example, one of them has a permanent establishment whose income is taxable in India.

Sub-section(2) of section 92B extends the scope of the definition of international transaction by providing that a transaction entered into with an unrelated person shall be deemed to be a transaction with an associated enterprise, if there exists a prior agreement in relation to the transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined by the associated enterprise. An illustration of such a transaction could be where the assesse, being an enterprise resident in India, exports goods to an unrelated person abroad, and there is a separate arrangement or agreement between the unrelated person and an associated enterprise which influences the price at which the goods are exported. In such a case the transaction with the unrelated enterprise will also be subject to transfer pricing regulations.

The new section 92C provides that the arm's length price in relation to an international transaction shall be determined by (a) comparable controlled price method; or (b) resale price method; or (c) cost plus method; or (d)profit split method; or (e) transactional net margin method; or (f) any other method which may be prescribed by the Board. For the present, no additional method has been prescribed. One of the five specified method shall be the most appropriate method in respect of a particular international transaction, and shall be applied for computation of arm's length price in the manner specified by the rules. Rule 10A to 10E, which have been separately notified vide S.O. 808(E) dated 21.8.2001 inter- alia, provide for the factors that are to be considered in selecting the most appropriate method. The major considerations in this regard have been specified to be the availability, coverage and reliability of data necessary for application of the method, the extent and reliability of assumptions required to be made, and the degree of comparability existing between the international transaction and the uncontrolled transaction. The Rules also lay down in detail the manner in which the methods are to be applied in determining the arms length price.

Applying the most appropriate method to different sets of comparable data can possibly result in computation of more than one arms length price. With a view to avoid unnecessary disputes, the proviso to section 92C(2) provides that in such a case the arithmetic mean of the prices shall be adopted as the arms length price. In normal course, if the different sets of comparable data are equally reliable there may not be any significant divergence between the various arm's length prices determined.

Under the new provisions the primary onus is on the taxpayer to determine an arms length price in accordance with the rules, and to substantiate the same with the prescribed documentation. Where such onus is discharged by the assesse and the data used for determining the arms length price is reliable and correct, there can be no intervention by the Assessing Officer. This is made clear by sub – section (3) of section 92C which provides that the Assessing Officer may intervene only if he is, on the basis of material or information or document in his possession, of the opinion that the price charged in the international transaction has not been determined in accordance with sub-sections (1) and (2), or information and documents relating to the international transaction have not been kept and maintained by the assesse in accordance with the provisions contained in sub-section (1) of section 92D and the rules made thereunder; or the information or data used in computation of the arm's length price is not reliable or correct ; or the assesse has failed to furnish , within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D. If any one of such circumstances exists, the Assessing Officer may reject the price adopted by the assesse and determine the arm's length price in accordance with the same rules. However, an opportunity has to be given to the assesse before determining such price. Thereafter, as provided in sub-section (4) of section 92C, the Assessing Officer may compute the total income on the basis of the arm's length price so determined by him.

The first provision to section 92C(4) recognizes the commercial reality that even when a transfer pricing adjustment is made that subsection, the amount represented by the adjustment would not actually have been received in India or would have actually gone out of the country. Therefore it has been provided that no deductions u/s 10A or 10B or Under Chapter VIA shall be allowed in respect of the amount of adjustment.

The second proviso to section 92C(4) refers to a case where the amount involved in the international transaction has already been remitted abroad after deducting tax at source and subsequently, in the assessment of the resident payer, an adjustment is made to the transfer price involved and , thereby , the expenditure represented by the amount so remitted is partly disallowed. Under the Income –tax Act, a non resident in resident in receipt of income from which tax has been deducted at source has the option of filing a return of income in respect of the relevant income. In such cases, a non resident could claim a refund of a part of the tax deducted at source, on the ground that an arm's length price has been adopted by the Assessing Officer in the case of the resident and the same price should be considered in determining the taxable income of the non-resident. However, the adoption of the arm's length price in such cases would not alter the commercial reality that the entire amount claimed earlier would have actually been received by the entity located abroad. It has therefore been made clear in the second proviso that income of one associated enterprise shall not be recomputed merely by reason of an adjustment made in the case of the other associated enterprise on determination of arm's length price by the Assessing Officer.

The new section 92D provides that every person who has undertaken an international transaction shall keep and maintain such information and documents as may be specified by rules made by the board. The Board may also specify by rules the period for which the information and documents are required to be retained. The documentation required to be maintained has been prescribed under Rule 10D. Such documentation includes background information on the commercial environment in which the transaction has been entered into, and information regarding in international transaction entered into, the analysis carried out to select the most appropriate method to identify comparable transactions, and the actual working out of the arms length price of the transaction. The documentation should be available with the assesse by the specified date defined in section 92Fand should be retained for a period of 8 years. During the course of any proceedings under the Act, an Assessing Officer or Commissioner (Appeals) may require any person who has undertaken an international transaction to furnish any of the information and documents specified under the rules within a period of thirty days from the date of receipt of a notice issued in this regard, and such period may be extended by a further period not exceeding thirty days.

The new section 92E provides that every person who has entered into an international transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form and manner Rule 10E and From No.3CEB have been notified in this regard. The accountants report only requires furnishing of factual information relating to the international transaction entered into, the arm's length price determined by the assesse and the method applied in such determination. It also requires an opinion as to whether the prescribed documentation has been maintained.

The new section 92F defines the expressions"accountant","arm's length price","enterprise", "specified date " and "transaction"used in sections 92,92A, 92B, 92C, 92D and 92E. The definition of enterprise is broad and includes a permanent establishment, even though a PE is not a separate legal entity. Consequently, transactions between a foreign enterprise and its PE, for example, between the head office abroad and a branch in India, are also subject to these transfer-pricingregulations. Also, the regulations would apply to transaction between a foreign enterprise and a PE of another foreign enterprise. The term permanent establishment has not been defined in the provisions but its meaning may be understood with reference to the tax treaties entered into by India.

With a view to ensure that multinational enterprises comply with the requirements of the new regulations, the Act has also amended section 271 and inserted new sections 271AA, 271BA, 271G in the Income –tax Act, so as to provide for penalty to be levied in cases of non – compliance with procedural requirements, and in cases of understatement of profits through fraud or willful negligence.

The new Explanation 7 to sub –section (1) of section 271 provides that where in the case of an assesse who has entered into an international transaction , any amount is added or disallowed in computing the total income under sub-sections (1) and (2) of section 92, then , the amount so added or disallowed shall be deemed to represent income in respect of which particulars have been concealed or inaccurate particulars have been furnished . However, no penalty u/s 271(1)(c) shall be levied where the assesse proves to the satisfaction of the Assessing Officer or the Commissioner (Appeals) that the price charged or paid in such transactions has been determined in accordance with section 92Cin good faith and with due diligence.

The new section 271AA provides that if any person who has entered into an international transaction fails to keep and maintain any such information and documents as specified under section 92D, the Assessing Officer or Commissioner (Appeals) may direct that such person shall pay, by the way of penalty, a sum equal to two percent of the value of the international transaction entered into by such person.

The new section 271BA provides that if any person fails to furnish a report from an accountant as required by section 92E the Assessing Officer may direct that such person shall pay by way of penalty, a sum of one lakh rupees.

The new section 271G provides that if any person who has entered into an international transaction fails to furnish any information or documents as required under sub-section (3) of section 92D, the Assessing Officer or the Commissioner (Appeals) may direct that such person shall pay, by the way of penalty, a sum equal to two percent of the value of the international transaction.

The Act has also amended section 273B to provide that the above-mentioned penalties under section 271AA, 271BA and 271G shall not be imposable if the assesse proves that there was reasonable cause for such failures.

CONCLUSION

From the foregoing it is obvious that transfer – pricing policy never works in the vacuum. It is affected by legal, tax and accounting guidelines of the host country. In turn, the transfer pricing also affects these aspects. A transfer pricing is a continuous process, and has to keep itself abreast of the developments in the environment. Indian laws have been alive to this issue, powerful as it is. This is a clear –cut response to fresh challenges posed by overseas multinationals and also signifies globalization and maturing of the Indian economy. Although this new insertion has been widely welcomed, the precise impact will be judged in a year or two.