LAW OF TRANSFER PRICING IN INDIA

1. INTRODUCTION

Increasing participation of multi-national groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same group. Hence, their was a need to introduce a uniform and internationally accepted mechanism of determining reasonable, fair and equitable profits and tax in India in the case of such multinational enterprises. Accordingly, the Finance Act, 2001 introduced law of transfer pricing in India through sections 92A to 92F of the Indian Income-tax Act, 1961 which guides computation of the transfer price and suggests detailed documentation procedures. This article aims to provide a brief overview on the applicability of transfer pricing regulations in India, methods of determining the transfer price and the documentation procedures.

2. SCOPE & APPLICABILITY

Transfer Pricing Regulations ("TPR") are applicable to the all enterprises that enter into an 'International Transaction' with an 'Associated Enterprise'. Therefore, generally it applies to all cross border transactions entered into between associated enterprises. It even applies to 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 and is known as the Arm's Length Price ('ALP').

2.1. Associated Enterprises ('AEs')- How Identified?

The basic criterion 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 control adopted in the legislation extends not only to control through holding shares or voting power or the power to appoint the management of an enterprise, but also through debt, blood relationships, and control over various components of the business activity performed by the taxpayer such as control over raw materials, sales and intangibles.

It appears that one may go to any layer of management, control or ownership in order to find out association

(a) Direct Control

(b) Through Intermediary

For instance, if enterprise B is managed, controlled or owned either directly or through an intermediary, then Enterprise B is said to be an AE of enterprise A.

Further, if Mr A and Mr B control both Enterprise A and Enterprise B then both Enterprise A and Enterprise B AEs.

2.2. What is an International Transaction?

An international transaction is essentially a cross border transaction between AEs in any sort of property, whether tangible or intangible, or in the provision of services, lending of money etc. At least one of the parties to the transaction must be a non-resident entering into one or more of the following transactions

(a) Purchase, sale or lease of Tangible or Intangible Property

(b) Provision of services

(c) Lending or borrowing of money

(d) Any transaction having a bearing on profits, income, losses or assets

(e) Mutual agreement between AEs for allocation/apportionment of any cost, contribution or expense.

An illustration of a distant 'International Transaction' could be where a resident enterprise exports goods to an unrelated person abroad, and there is a separate arrangement or agreement between the unrelated person and an AE 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 TPR.

3. METHODS OF DETERMINING THE ALP

In accordance with internationally accepted principles, the TPR have provided that any income arising from an international transaction between AEs shall be computed having regard to the ALP, which is the price that would be charged in the transaction if it had been entered into by unrelated parties in similar conditions.

The ALP is to be determined by any one or more of the prescribed methods. The taxpayer can select the most appropriate method to be applied to any given transaction, but such selection has to be made taking into account the factors prescribed in the TPR. With a view to allow a degree of flexibility in adopting the ALP, a variance allowance of 5 percent has been provided under the TPR. The prescribed methods have been listed below

(a) Comparable Uncontrolled Price Method ('CUPM')

(b) Resale Price Method (''RPM')

(c) Cost plus method ('CPM')

(d) Profit Split Method ('PSM')

(e) Transactional Net Margin Method ('TNMM')

4. DOCUMENTATION

The provisions contained in the TPR are exhaustive as far as the maintenance of documentation is concerned. This includes background information on the commercial environment in which the transaction has been entered into, information regarding the international transaction entered into, the analysis carried out to select the most appropriate method and to identify comparable transactions, and the actual working out of the ALP of the transaction. This also includes report of an accountant certifying that the ALP has been determined in accordance with the TPR and that prescribed documentation has been maintained. This documentation should be retained for a minimum period of 8 years.

However, it may be noted that in case the value of the international transaction is below INR 10 million, it would be sufficient for the taxpayer to maintain documentation and information which substantiates his claim for the ALP adopted by him. In effect, they need not maintain the prescribed documentation.

5. BURDEN OF PROOF - TAXPAYER OR TAX OFFICER?

The primary onus is on the taxpayer to determine an ALP in accordance with the TPR and to substantiate the same with the prescribed documentation. Where such onus is discharged by the taxpayer and the data used for determining the ALP is reliable and correct there can be no intervention by the tax officer.

In other cases, where the tax officer is of the view that the

(a) price charged in the international transaction has not been determined in accordance with the methods prescribed,

(b) or information and documents relating to the international transaction have not been kept and maintained by the assessee in accordance with the TPR,

(c) or the information or data used in computation of the ALP is not reliable or correct,

(d) or the assessee has failed to furnish any information or document which he was required to furnish under the TPR

the tax officer may reject the ALP adopted by the assessee and determine the ALP in accordance with the TPR. For this purpose, he would then refer the matter to a Transfer Pricing Officer ('TPO') (a special post created for valuation of ALP) who would determine the ALP after hearing the arguments of the taxpayer.

6. EFFECTS OF ADJUSTMENT TO THE ALP

In case the ALP determined by the TPO indicates understatement of income by the taxpayer, it could result into the following

(a) Adjustment to reported income of the taxpayer

(b) Levy of penalty

6.1. Adjustment to the Reported Income

The tax officer is bound to adjust the reported income of the taxpayer with the amount of adjustment proposed by the TPO. This would have an effect of increasing the assessed income or alternatively decreasing the assessed loss. Furthermore, the eligible deductions available to the taxpayer under section 80 could not be availed on the enhanced income. However, those taxpayers who are eligible for deductions under section 10A and 10B remain unaffected as these deductions remain available on the enhanced income.

6.2. Penalties

Penalties have been provided as a disincentive for non-compliance with procedural requirements are as follows.

(a) Penalty for Concealment of Income - 100 to 300 percent on tax evaded

(b) Failure to Maintain/Furnish Prescribed Documentation - 2 percent of the value of the international transaction

(c) Penalty for non-furnishing of accountants report - INR 100,000 (fixed)

The above penalties can be avoided if the taxpayer proves that there was reasonable cause for such failures.

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