

**TRANSFER PRICING**

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To,  
Clients & Friends,

This year the Finance Minister has announced very significant "Transfer Pricing Rules". All transactions with non-residents will be affected by these rules.

After enacting the law, initially the government had come out with draft rules. There were some serious issues in the draft rules. Various professional organisations, trade organisations, OECD and ourselves had made suggestions. The government has been quite open to suggestions. After considering suggestions from various bodies, the rules have been finalised. The rules are more or less on the lines of OECD guidelines. We have enclosed a brief note on these rules.

Should you require any further information, kindly contact us.

Thanking you,

Yours sincerely,  
For Rashmin Sanghvi and Associates

Rashmin Sanghvi

Naresh Ajwani

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# TRANSFER PRICING

## 1. Significance of Transfer Pricing (TP)

Every country is entitled to its due share of tax revenues. On account of globalisation of business, persons who operate in various countries, can so arrange their affairs, that profits can be **transferred** from a high tax country, to a low tax country.

This causes loss of tax revenue to the Government.

To give a simplified illustration:

An automobile manufacturer can split the transactions into various processes.

Activity	Country	Percentage of Profits
Designing of the car	U.S.	20%
Body manufacturing	Italy	20%
Engine manufacturing	Japan	40%
Assembly	India	20%
	<b>Total</b>	<b>100%</b>

Under ideal circumstances, profits earned by the automobile manufacturer should be taxed according to the profits earned in the respective country. However, if the manufacturer finds the taxes in Japan to be high, then it can transfer the profits from Japan, to say, India.

This can be done if the Indian company / factory purchases the engines at prices lower than the market price from the Japanese company. The Japanese company / branch will receive lower prices and thus will earn lower profit in Japan. In India the profit will be higher.

Transfer Pricing rules attempt to plug such kind of practices.

It is estimated that 60 to 70% of International tax disputes relate to TP. Hence many countries have TP rules.

## 2. Basis of TP rules

Organisation of Economic Co-operation & Development (OECD) has come out with detailed and excellent guidelines on this subject. Several countries have borrowed from the report and modified the rules as per their requirements. India has also done the same. A high powered committee was appointed by Ministry of Finance in November, 1999. It has submitted its report a few months ago. The report is a classified document. It appears however that the

government has taken the report into consideration and come out with the rules. It must be mentioned that within two months from the submission of the report, the Indian government has come out with TP rules, which is quite commendable.

The Central Board of Direct Taxes (CBDT) had come out with draft rules providing for various guidelines. Several representations were made by the industry associations, professionals & OECD. CBDT has been very open, & at the time of final rules, they have removed some difficult issues. These have been discussed at appropriate places.

CBDT itself has accepted that everyone is in a learning phase. Hence the implementation will be liberal in the initial one or two years.

### **3. Arm's Length Principal (ALP)**

A very important principle governing TP is “**Arm's-Length Principle**” (ALP). ALP signifies that all transactions between associated (related) enterprises should be considered for tax purposes at ALP – prices. Simply put, the transaction prices should be considered as if the enterprises were unrelated.

The principle is simple to understand, but difficult to apply. Some reasons for difficulties are explained below.

### **4. Difficulties in applying the principle**

There can be several reasons (apart from the association) for charging a particular price to a customer. Among other reasons, the prices are influenced by:

- “What the traffic can bear”;
- Reliability of the customer;
- Volume of business;
- credit period;
- Risks undertaken by the vendor. If the vendor takes a higher risk, the price may be higher;
- market risk;
- political and economic risks of the country of the customer (Country Risk).

There can be many other reasons not envisaged here.

#### **Example 1**

Generally, different terms & conditions will mean different prices. For example, if a customer pays the price upfront, we may charge him a lower price. If credit has to be given, he may be charged a higher price, or he may be charged interest. This is a simple example. Let us see another one.

#### **Example 2**

If a holding company sells goods to its subsidiary company, there is hardly any credit risk, compared to a sale to an independent customer. Does it allow

the holding company to charge lower price to the subsidiary compared to an independent customer?

OECD guidelines clearly mention that the prices between related & independent parties must be compared under **comparable situations**. If there is a difference in the situation, appropriate adjustment must be made.

Thus, a sale to a subsidiary involves lower credit risk. Therefore, an appropriate adjustment is permitted. However, how much should be the adjustment?

If the enterprise has similar clients which have little credit risk, the prices charged to them can be compared. But what if there are no customers, other than the subsidiary? How does one compare the prices with other customers?

This will create difficulties. One may have to compare prices of goods charged by other businessmen (in similar industry) in the market and then try to make a comparison.

**This means that the exercise involves knowledge of market economies, business knowledge, etc.**

We know that each business is different. Each assessee and each transaction can be different. There are several factors which go into determining the price.

How does one keep a track?

How will the tax department know about all businesses?

How will tax auditors know about all businesses?

## 5. Guidelines for ALP

OECD accepts that there are several factors for determining the price of the products and services products & services. There can be no absolute test or any absolute price. One can charge different prices to different customers. One can charge different prices to the same customer at different times. A good example is of Coca-cola. Coca Cola company may sell a can of Coke for say U.S. \$ 1 (Rs. 47) in the U.S., and for Rs. 15 in India. The reasons are differences in exchange rates. Transfer Pricing rules do not suggest that Coca-Cola must sell a Coke can at Rs. 47/- in India.

OECD has prescribed various methods for determining the arm's-length price. Different situations may demand different methods to be applied.

Indian rules have also prescribed different methods. In the draft rules, the CBDT had prescribed which methods will be more appropriate than the others. Normally, the assessee is the person who can determine which method is appropriate to his business. CBDT has been open to suggestions. In the final rules, it has been provided that the method most appropriate to the situation will be applied.

With the help of these guidelines, one can determine a range of prices. As long as the prices are within a reasonable range, it should be considered alright.

If however, the price is beyond the range, then TP rules can be involved. Unfortunately the Income tax Act does not permit such a range. In fact as per the Income tax Act, if more than one prices are determined as per one method, then the average has to be taken. This is against the fundamental principles of international taxation. There cannot be one price. One has to allow for a range.

The acceptance of a range of prices has to be provided in the act itself. The amendment in the act can take time. Therefore, CBDT has tried to reduce the difficulty to a small extent in their circular. It has been stated that if the arm's length price calculated by the tax officer varies upto 5% either way as compared to the price calculated by the assessee, then no adjustment will be made to the profits. Thus CBDT has prescribed a tolerance zone for its officers.

## **6. Documents**

Transfer Pricing rules require persons to maintain various documents. The documents should establish whether the prices which have been charged are on the basis of arm's-length principle. The tax department has prescribed rules for maintenance of the documents.

The documents should establish that the person has done business with its associated enterprise at arm's-length prices. The documents include information regarding ownership pattern of the person, contracts entered into with associated enterprises & other enterprises, economic & market analysis, forecasts, budget, etc.

In the draft rules, the documents had to be kept by all persons who have done business with associated enterprises. However, in the final rules, CBDT has provided that those who have transactions with AE of less than Rs. 1 crores, need not maintain the specified documents. They must only establish that transactions are at market prices. This a very important relief given by CBDT.

## **7. Onus of establishment of ALP**

Primarily it is the businessman who is required to maintain records & establish that transaction with related parties are at arm's-length.

## **8. Types of transactions covered**

TP rules cover following types of transactions between associated enterprises (AE).

- 8.1 All incomes earned (or avoided) from associated enterprises. If one associated enterprise supplies to another associated enterprise, goods or services, it must charge prices based on ALP.
- 8.2 Expenses paid (or not paid) to an AE. If an associated enterprise, pays expenses to another A. E. , it must pay at ALP. And where applicable, it must recover expenses at ALP.
- 8.3 Sharing of expenses. The parent company can incur common expenses for the group (e.g. Hongkong Bank spends large amounts for setting up computer

servers and software for e-banking. All its subsidiaries may have to share the costs). The sharing of the costs should be as per ALP of the services / benefits received.

## **9. Audit**

Indian law provides that an audit of international transactions has to be done. An audit report has to be furnished every year.

## **10. Consequences of Transfer Pricing Rules.**

10.1 If the prices actually charged are not at ALP prices, for tax purposes, the assessee has to reconsider the profits having regard to ALP prices and file returns accordingly. He has to explain why the prices considered by him are different from ALP. The assessing officer may adjust the net profit if by adopting the Transfer Pricing rules, the profits would be different from the profits as per accounts.

Thus all transactions between associated enterprises are covered.

### **10.2 Can a person charge a price different from ALP?**

In reality there can be several reasons for charging a price, different from ALP. Consider 2 different examples.

#### **Example 1**

A holding company in India may want to support its subsidiary company in Hongkong. Hence it may buy goods from it at a higher price than that prevailing in the market.

#### **Example 2**

A foreign holding company gives interest free loan to its Indian subsidiary to support it.

Both the above transactions are for valid reasons. However for the purpose of income-tax, both the transactions will have to be re-stated at ALP.

### **10.3 Implications**

10.3.1 In the first example, Indian company, will have to claim a lower cost for purchase (therefore have a higher taxable income). In the second example, the foreign company will have to pay Indian tax on notional interest.

This is because, had the transactions been between independent parties, India would have got a higher share of taxes.

**This however does not change contractual obligations between the A. E.** i.e. In the first example, the Hongkong subsidiary will not have to refund the money for excessive price it receives from the Indian holding company. In the second example, the subsidiary will not have to actually pay interest, or show it as a cost in its annual accounts. But for tax purpose, the transactions have to be re-stated by way of a separate working.

### 10.3.2 Penalty

This is an important issue.

As discussed in the above para, there can be valid reasons for charging prices different from market prices. The difference between the market price, & the actual price may be taxable in India. The concerned country should get its tax revenue. **But as per OECD, such increase in income should not be considered as tax evasion.**

However, the manner in which the Indian law is proposed, if the assessing officer, makes any addition of income on account of TP, it will be considered as tax evasion. Penalty can be levied. It is then on the person to prove that he acted in good faith and with due diligence. This is a difficult exercise. As long as a person has acted in good faith, there should be no penalty. Only if there is a fraud or deliberate attempt to evade taxes, there should be penal consequences. For this, the onus should be on the tax officer.

### 10.3.3 Compensating effect on the other enterprise

1. In the example in para 10.2, the holding company which has lent interest free funds will be liable to tax on a notional basis. Does it mean, the Indian subsidiary can claim deduction of interest?

OECD guidelines provide that compensating adjustments should be made. However, there is no such provision in the proposed Indian TP rules.

This is an issue of **same country** providing or not providing compensating adjustment for the **other party** to the transaction.

2. Similarly there is the issue of the other country providing compensating adjustment.

Thus consider the illustration of Hongkong subsidiary providing goods to Indian holding company. India would tax the Indian company as if it had purchased goods at a lower price. Will Hongkong tax the subsidiary as if it had sold goods at a lower price?

3. Consider foreign holding company providing interest free loan to Indian subsidiary. Indian Government would tax the foreign company as if it had charged interest. Would the foreign Government provide set off for such tax under Double Tax Avoidance Agreement!

These are some issues for which there may not be specific answers. The law has to evolve.

## 11. In summing up

Transfer Pricing rules exist in most of the developed countries. It will be essential to understand the implications of the rules. Business persons should maintain proper records to establish that taxable profits are determined have regard to ALP for business transactions.

Rashmin Sanghvi

Naresh Ajwani

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We have tried to give, in brief, authentic information. However, this booklet does not amount to rendering any advice or any professional service.