"AN ANALYTICAL STUDY OF TRANSFER PRICING"

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Abstract:

Globalization has removed all the geographical boundaries, which provides a lot of opportunities for the growth of business but it also creates a problem in front of tax authorities because taxes are imposed within the boundaries of the Nation. Multinationals Companies are the result of globalization which wants to expand their business in more than one nation of the globe but they have to pay very crucial part of their income as tax to various nations. So to mitigate and reduce their tax liabilities entities follow many practices, transfer of goods and services to their subsidiaries or associates enterprises is one of them. The fact is that, nowadays the trade has become global trade which consists of international transfers of goods and services, capital and intangibles within a MNE group; such transfers are called "intra-group" transactions. The arrangement of transactions within group of MNEs ("associated enterprises" in the language of transfer pricing) can be fixed by a combination of the market and group.

Keywords: *Base erosion and profit shifting, Organization for economic cooperation and development, Multinational companies, Low tax jurisdictions, Associated enterprises.*

LIST OF ABBREVIATIONS

BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
CPM	Cost Plus Method
CUPM	Comparable Uncontrolled Price Method
IT	Income Tax
MLE	Multi Location Enterprises
MNC	Multi-National Companies
MNEs	Multi National Enterprises
OECD	Organization for Economic Co-operation and Development
PE	Permanent Establishment
PSM	Profit Split Method
RPM	Resale Price Methods
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
TPR	Transfer Pricing Regulations
UK	United Kingdom
UN	United Nations
US	United States
USA	United States of America

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1.1 Introductory

After the rapid advances in technology, transportation and communication large number of multinational enterprises (MNEs) has been arisen, which have the flexibility to place their enterprises and activities anywhere in the world. The fact is that, nowadays the trade has become global trade which consists of international transfers of goods and services, capital and intangibles within a MNE group; such transfers are called “intra-group” transactions. There is prove that intra-group exchange is developing relentlessly and ostensibly represents more than 30 per cent of international exchange.

Furthermore transactions involving intangibles and multi-tiered services have constituted a rapid growth in proportion of an MNE’s commercial transactions because of which there is great increment of the complexities involved in analyzing and understanding such transactions.

The arrangement of transactions within group of MNEs (“associated enterprises” in the language of transfer pricing) can be fixed by a combination of the market and group. This can differ from the open market conditions operating between independent entities. In this way, a vast and developing number of global exchanges are never again represented altogether by market forces, yet by powers which are driven by the common interests of the entities of a group.[3]

Transfer pricing is the term used for the pricing of international, intra-firm transactions between related parties. Therefore “transfer pricing” refers to the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, which are forming part of an MNE group. These transactions are known as controlled which are distinct from uncontrolled transactions between companies that, for example, are not associated and can be assumed to operate independently (“on an arm’s length basis”) in reaching terms for such transactions.[4]

1.2 Research Objectives

a) To study transfer pricing as it is an important constituent of Base Erosion and Profit Shifting.
b) To study the issues raised by OECD.

1.3 Meaning of Transfer Pricing

“Transfer pricing” is the science of determination of Price for transfer of goods or services between associated enterprises belonging to same multinational group, operating in different tax jurisdictions. The international transactions within organization is generally not market driven but is influenced and controlled by the relationship of enterprises in the multinational group so as to maximize the overall post-tax profits of the group as a whole. Generally, transfer pricing is a price of transferring goods and services among the overall corporate family.

Business transactions between the distinctive parts of the MNC groups may not be subject to the same market forces shaping relations between the two independent firms. One party transfers to another, goods or services for a price that price is known as “transfer price”. This may be autocratic and dictated, without having any relation to cost and value addition, diverge from the market forces. But, the word “transfer pricing” refers to prices of transactions between associated enterprises which take place under conditions differing from those taking place between independent enterprises. It refers to the value associated to transfers of technology, goods and services between related entities. It also unrelated parties which are controlled by a common entity.

For example: suppose a company ABC purchases goods for 10000 rupees and sells it to its associated company XYZ in another country for 15000 rupees, who in turn sells in the open market for 20000 rupees. Had ABC sold it direct, it would have made a profit of 10000 rupees. But by routing it through XYZ, it restricted it to 5000 rupees, permitting XYZ to appropriate the balance. The transaction between ABC and XYZ is arranged not governed by market forces. The profit of 5000 rupees is thereby, shifted to the country of XYZ. The goods are exchanged on a price (transfer price) which is discretionary or dictated (15000 rupees), but not on the market price (20000 rupees)

By transfer pricing the parent company or a specific subsidiary tends to show insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. As an example of this, a group of which manufacture

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[3]Available at < http :// www. un. org / esa / ffd / tax / 2011 _ TP / TP _ Chapter1 _ Introduction. pdf >

(Last accessed on 1 April 2014).

[4]*Ibid*

products in high tax countries may decide to sell them at low profit to its affiliate sales company based in a tax haven country. That company would in turn sell the product at an arm's length price subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves.[5]
Therefore, transfer pricing is a trick of moving technologies, goods and services from one person or subsidiary to another without generating a lot of postings in the books of accounts. The value of the goods or services is easily transferred from one entity to another, a process that greatly simplifies the process. While the fundamental purpose behind the transfer pricing is to improve the overall value of the corporate family, there are instances when this sort of transaction can be abused. This is particularly genuine when exchanges to worldwide areas are led. Now a days, all most all nations have their guidelines and regulations to help prevent the use of this pricing method as a means of evading taxes or similar unethical and illegal activities.[6]

1.4 Organization for Economic Co-operation and Development Report Views

The report of OECD on "Addressing Base Erosion and Profit shifting" describes the transfer pricing as one of the key principle which underlie the taxation of profits from cross-borders activities and as one of the BEPS opportunities this principle may create. Further it explains that the issue of jurisdiction to tax is closely linked with the one measurement of profits: once it has been established that the share of an entity's profits can be considered to originate from a jurisdiction and that the jurisdiction ought to be permitted to tax it, it is necessary to have rules for the determination of relevant share of the profits which will be subjected to taxation. Transfer pricing rules perform this function. The worldwide accepted standard underlying transfer pricing related parties must assign income as it would be apportioned between independent entities in the same or similar circumstances.

When unassociated enterprises transact with each other, the conditions of the transaction are generally determined by market forces. When related enterprises transact with each other, their conditions may not be directly affected by market forces in the same way. The objective of the arm's length principle is for the price and other conditions of transactions between associated enterprises to be consistent with those that would occur between unrelated enterprises for comparable transactions under comparable circumstances. In transactions between two unassociated enterprises, return usually will reflect the functions that each enterprise performs, taking into account assets used and risks assumed. Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a comparability analysis is needed to ensure that the economically relevant characteristics of the situations being compared are sufficiently comparable. One of the important factors in that comparability analysis is an utilitarian analysis to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.

This principle, originally developed by the League of Nations, is contained in the domestic legislation of most countries and is embodied in Article 7 and Article 9 of the OECD and UN Model Treaties and in virtually all double taxation treaties. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the Guidelines") and the OECD Report on the Attribution of Profits to Permanent Establishments provide guidance on how to apply Articles 7 and 9 of treaties based on the OECD Model Tax Convention. The first report of the OECD on transfer pricing was issued in 1979. In 1995, the report was replaced by new extensive guidelines. The introduction of the Guidelines was followed by the recognition that it was necessary to set in place explicit transfer pricing legislation, including documentation requirements. As a consequence, more and more governments introduced transfer pricing legislation and related documentation requirements. Although the large majority of domestic transfer pricing systems are based on the arm's length principle, each domestic system has its own specificities and reflects domestic country positions on transfer pricing.

Transfer pricing arrangements which are generally used to shift income related to the contractual allocation of risks and intangibles often involve thorny questions. One essential question includes the circumstances under which a taxpayer's particular allocation of risk should be acknowledged. Such risk and income allocation outcomes stated to follow from them can become a source of controversy. The assessment of risk generally involves discussions regarding whether, in fact, a low-tax transferee of intangibles should be treated as having borne, on behalf of the MNE group, significant risks related to the development and use of the intangibles in commercial operations. Such disputes put pressure on the capacity of tax administrations to inspect the content

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[5]Available at < http :// law .incometaxindia. gov. in / DIT / File _ opener . aspx ? fn = http :// law. Incometaxindia . gov .in / Directtaxlaws / act 2005 / tp1. htm > (Last accessed on 1April, 2014).
[6]Available at < http : // www. wisegeek . org / what –is – transfer – pricing . htm > (Last accessed on 2 April 2014)

of such arrangements, and determine whether the results of such arrangements, viewed in their totality, are consistent with policy norms (*i.e.* avoidance of inappropriate base erosion).

Transfer pricing rules regarding the attribution of risks and assets within a group are applied on an entity-by-entity basis, thus facilitating planning based on the isolation of risks at the level of particular members of the group. There are a number of examples of risk allocations that can be undertaken under the arm's length principle between members of an affiliated group (*e.g.* low-risk manufacturing and distribution, contract R&D and captive insurance). Under each of these models, the principle/insurer could be located in a low-tax jurisdiction, and the service provider/insured located in a high-tax jurisdiction. A key challenge is determining the circumstances under which such arrangements result in or contribute to base erosion, and principles under which the base erosion is addressed.

1.5 Section 92A – Meaning of Associated Enterprise

For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise[7]which participates, directly or indirectly, or through one or more intermediaries, in the capital or control or management of the other entity; or in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in capital or control or management of the other entity.

For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,—

- I) One enterprise owns, more than twenty-six per cent shares with the voting rights, in the other enterprise though directly or indirectly; or
- II) Any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or
- III) A loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or
- IV) One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or
- V) More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or
- VI) More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of knowhow, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or
- VII) More than ninety per cent of the consumables and raw materials required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or
- VIII) The products or services produced or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or
- IX) Where one enterprise is controlled or managed by an individual and the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or
- X) Where one enterprise is controlled and governed by members of Hindu undivided family, the other enterprise is also controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or

[7] *Ibid*

XI) Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or

XII) There exists any relationship of mutual interest between the two enterprises, as may be prescribed.

Section 92A gives in detail the meaning of associated enterprise. Sub-section (1) provides two situations, one enterprise directly or indirectly participates in the management, control or capital of the other enterprise. In the 2nd condition, when the same person participate in the control and management or capital of two enterprises though directly or indirectly, then the two enterprises would be enterprises would be associated enterprise would be deemed to be associated enterprise.

On a plain reading of above provision, it comes out that mere participation in the management or control or capital of the other enterprise is sufficient to establish a relationship of Associated Enterprises. It was construed as such since sub-section (2) of section 92A starts with the wordings: *"Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year……"* However, Finance Bill 2002 makes an amendment in the above wordings of Section 92A(2) which reads as under: *"For the purposes of sub-section (1) of section 92A, two enterprises, if at any time during the previous year……."*

It can now be seen that after amendment mere participation in the management or control or capital of the other enterprises will not be sufficient. It should also satisfy any of the criteria as mentioned under sub-section (2) of section 92A of the Act. Even the memorandum explaining the Finance Bill 2002, clearly brings about this intention by stating as under: *"The existing provisions contained in section 92A of the Income Tax Act provide as to when two enterprises shall be deemed to be associated enterprises. The Finance Act, 2002 has amended sub-section (2) of section 92A to clarify that where any of the criteria specified in sub-section (2) is fulfilled: two enterprises shall be deemed to be associate enterprises."* Sub-section (2) of section92A is very wide in its commutation and it tries to cover as much possible relationship that may happen. It lays down the various types of relationship between two enterprises so as to call them associated enterprises.[8]

1.6 Meaning of International Transaction (Section 92B)

Section 92B covers the definition of "international transaction". This definition as covered in this section is very wide and attempts to cover a wide variety of transactions. As per sub-section (1) of section 92, International Transaction means a transaction between:

a. two or more associated enterprises, either or both of whom are non-residents, in nature of:

i) purchase, sale or lease of tangible or intangible property, or
ii) provision of services, or
iii) lending or borrowing money, or
iv) any other transaction, having bearing on the having bearing on the:
 a) profits
 b) income,
 c) losses, or
 d) assets of such enterprises, and shall include:

all those agreement or arrangements which are mutually signed between two or more associated enterprises for the allocation or apportionment of, any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to any one or more of such enterprises.

On making analysis of the above provisions it is pretty much clear that the very basic requirement of 'international transaction' is that one of the parties to the relevant transaction must be a non-resident. However if both the parties to the relevant transaction would be taxable under this provision provided such a transaction does have any impact or connection on Indian resident, otherwise it would simply be a transaction between two non-residents which won't be taxable under the Act.

Further, section provides that after being determined the relationship and residential status of the enterprises and at least one of them as non-resident respectively, then the transaction being entered between such parties be considered as international transaction if it is in the nature of:

i) purchase, sale or lease of tangible or intangible property, or
ii) provision of services, or

[8]Income Tax Act, 1961, *Universal Law Publishing Co. Pvt. Ltd.,* 2013

iii) lending or borrowing money

It is to be noted that all the above transactions needs to have an impact on either

a) profits,
b) income
c) losses, or
d) assets of such enterprises.

However, this sub section provides further flexibility by stating that any other transaction, not covered under above nature of transactions, would still be considered to be an international transaction if such transaction does have an impact on profits, income, losses or assets of such enterprises. Conversely, we can say that a transaction would not be considered to be an international transaction even if it has been entered into between into two associated enterprises, one of them being the non-resident, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money but it doesn't have any impact/bearing on profits, income, losses or assets of such enterprises.

This section further provides that apart from all of the above nature of transactions, following shall still be considered to be an international transaction:

i) A mutual agreement or arrangement between two or more associated enterprises.
ii) For the allocation or apportionment of, or
iii) Any contribution to,
iv) In connection with a benefit, service or facility
v) Provided or to be provided to
vi) Any one or more of such enterprises.

Sub section (2) of the section 92 B provides a deeming fiction by stating that for the purposes of sub section (1), a transaction entered into between two associated enterprises, if

i) There exists a earlier agreement in connection to the significant transaction between such other person and the associated enterprise, or
ii) The terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

For example – X ltd. in Indian and Y ltd. in U.K. are associated enterprises. Now, there is one more enterprise Z ltd. in Malaysia with which X ltd. entered into a transaction of lending the money. However, there exists a prior agreement between Y ltd. and Z ltd. in respect of such a transaction. Hence, by virtue of sub section 2 of section 92B such a transaction would be considered to have been entered into between two associated enterprises.

It is worth to be noted here that sub section (2), provides deeming fiction of associated enterprises between two enterprises for the purpose of sub-section (1) only. It means, if the nature of transaction between two unassociated enterprises is one which is being mentioned under the sub-section (1), then for the purpose of such transaction only such unassociated enterprises would be considered to be associated enterprises would be considered to be associated enterprise provided the conditions as envisaged under sub-section (2) is fulfilled in respect of such transactions.

1.7 Extension to Domestic Transaction

As per section 92BA, the transfer pricing regulations would also apply to certain domestic transactions. Accordingly amendments have been made in sections 92, 92C, 92D and 92E. In order to provide precision in the assessment of income from domestic transactions and determination of the reasonableness of expenditure within associated domestic parties, the scope of transfer pricing provisions was extended to domestic transactions.[9] Section 92BA refers to specified domestic transactions. Therefore, the transfer pricing regulations are extended to the transactions entered into by domestic related party for the purposes of any expenditure in respect of which payment has been made or is to be made to a person referred to in section 40A (2) (b), any transaction referred to in section 80-IA(10), any transaction under section 10AA or any other transaction which may be prescribed.

After examining all the complications arise in cases the Supreme Court in *CIT v. Glaxo Smithkline Asia (P)*

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[9]S.Rajaratnam, "Transfer Pricing", *Company Law*, Chennai, 2013, p. 220

Ltd.[10], where fair market value is to be assigned to transactions between domestic transactions. Therefore, the transactions between domestic related party suggested provisions in law is intended to make transfer pricing regulations applicable to domestic transactions from 1st April, 2013.
The concerns of administrative and compliance burdens have been addressed by restricting its applicability to the transactions which a monetary limit of Rs. 5 Crore.

1.8 Methods for arriving at Arm's Length Price

Section 92C refers to the most appropriate method of calculating the arm's length (ALP) in relation to an international transaction having regard to the nature or class of transactions. The following have been prescribed in relation to the same:

a) Comparable uncontrolled price method,
b) Resale price methods,
c) Cost plus method,
d) Profit split method,
e) Transactional net margin method,
Any other method as may be prescribed by the Board.

1.9 **Conclusion**

It is evident from the aforesaid discussion that in order to understand the transfer pricing mechanism, one should be crystal clear about the different relationships, which give the status between two or more enterprises that of the associated enterprises in relation to an International Transaction. In history of in our tax laws transfer pricing was formally recognized in international transactions. In international trade, emergence of multinational enterprises (MNE) where the parent was in one country and the subsidiaries and branches were in other countries, the transactions between group entities gave scope for shifting income from one country to the other, so that tax administration evolved rules of determination of arm's length principle to ensure that transfer prices between members is based on the concept of prices determined in uncontrolled transaction determined by the market forces. Transfer pricing analysis involves domestic enterprises and foreign enterprises. The treaties comprise certain article on "Associated Enterprises" for the application of arm's length price principle.

[10] 8 Taxmann.com 5 (SC).